Legal Reforms in The Aftermath of the Financial Crisis: Opportunities and Challenges for Emerging Market Economies [1]

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I. Introduction

The financial and economic crisis commenced in 2008 is seen as the most dramatic crisis after the Great Depression. Many major economies, including emerging markets were heavily affected during the crisis. Although it is difficult to argue that the crisis has come to an end, it has already changed the paradigms of financial markets and financial regulation.

The history of financial regulations both nationally and internationally reflects the fact that there have been financial crises and then regulatory responses. In other words, the history of financial regulation is also the history of financial crises.

The recent financial crisis was not an exception. After the recent financial crisis, there have been significant regulatory efforts in some major economies, in the EU and at the international level to change the rules of the game in the financial markets. These regulatory reforms may present some opportunities and challenges for emerging market economies. The aim of this article is to explain these regulatory movements and their effects on emerging market economies.

In terms of the structure, first, brief information regarding the international financial law and international financial organizations will be given, which are essentially different from traditional international law and organizations. Second, some regulatory reforms conducted by international organizations as well as the US and EU after the recent financial crisis will be explained. Then, I will explore to what extent these regulatory reforms at

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1 The article, presented at 'Reopening the Silk Road in the Legal Dialogue between Turkey and China', 12-14 June 2012, Law School of Marmara University, Istanbul/Turkey, reflects the developments until June 2012.

the international arena, in the US and EU will affect the emerging market economies. Finally, the article will be concluded with some observations and suggestions.

II. International Financial Law

Financial law, initially, was developed in the domestic context to regulate and supervise financial markets and institutions. However, several factors including technological developments, globalisation, financial innovation, and international and supranational regulatory developments have increased the cross-border financial activities. This created the need for international financial regulation and supervision to ensure consistent and coherent national practices across the world. In the meantime, the international financial crises together with the aforesaid factors have reinforced the role of international financial organizations especially in the rule-making process. After the recent global financial crisis, these international financial organizations and the rules issued by them have become even more popular, and attracted too much attention than before.

In order to understand these organizations and developments, the nature of international financial law, international financial architecture, some important examples of international standards and implementation and enforcement of international financial law will be elaborated under this section.

A) The Nature

The nature of international financial law presents its different and in the meantime interesting features. Essentially, international financial law is issued by international financial organizations and standard-setters, most of which lack formal legal status. It generally reflects minimum requirements. International financial law is basically soft law, not binding, but implemented voluntarily.[2] It is enforced through market mechanisms and some institutional sanctions, as elaborated below. There are several soft law instruments: including, but not limited to, standards, principles, guidelines, code of conduct, best practices, and memorandum of understanding.[3]

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2 Lastra notes that enforcement is the key element for distinguishing between hard and soft law. See Lastra, Rosa M., Legal Foundations of International Monetary Stability, (OUP, 2006), 454.

3 Brummer classifies soft law instruments in three categories: best practices, regulatory reports and observations, and information sharing and enforcement cooperation agreements. See Brummer, Chris, Soft Law and the Global Financial System: Rule Making in the 21st Century, (CUP, 2012), 116-119.

These are the basic features of the international financial law, which also show us the differences between the traditional international hard law and the international financial law. These features are partly elaborated throughout this article.

B) International Financial Architecture

International financial architecture generally refers to international financial law as well as formal or informal international organizations and standard-setters that contribute to the rule-making, monitoring and enforcement processes for international financial standards.[4] The latter aspect of the international financial architecture is analysed in this section.

In the absence of a formal global financial regulator, international financial standards are frequently agreed among national regulatory and supervisory authorities under the umbrella of aforesaid international organizations or standard-setters. In this regard, international financial architecture reflects a fragmented structure, and consists of various formal international institutions established by the international agreements as well as informal international financial institutions, meetings and groups established by soft law.

According to Brummer, the international financial regulatory system consists of entities that specialise in setting agendas for the international regulatory system such as the Group of Twenty (G20) and the Financial Stability Board (FSB), bodies that focus on standard setting itself such as Basel Committee on Banking Supervision (Basel Committee) and International Organization for Securities Commissions (IOSCO), and institutions that monitor the system and check for compliance with the regulatory requirements such as the International Monetary Fund (IMF) and the World Bank.[5] Some of these institutions and organizations are briefly introduced below.

The Group of Twenty: The G20 is the premier forum for international cooperation on the most important aspects of the international economic and financial agenda. It brings together the world's major advanced and emerging economies. The G20 includes 19 country members and the European Union, which together represent around 90% of global GDP, 80% of global trade and two-thirds of the world's population. The objective of the G20 is to ensure policy coordination between its members in order to

4 See Lastra, (n 2), 449-450.
5 See Brummer, (n 3), 68-69.

achieve global economic stability, sustainable growth; to promote financial regulations that reduce risks and prevent future financial crises; and to create a new international financial architecture.[6] Until the financial crisis 2008, the G7 operated as the primary agenda setter. Given the consensus over the fact that global economic governance required the participation of key emerging countries, the G20 became official primary forum for international economic coordination.

Financial Stability Board: The second important agenda setter is the FSB, which in many ways operates as a technocratic extension of more political G20. In the aftermath of the financial crisis, the Financial Stability Forum was superseded by the FSB which was given a broader mandate to assess and improve the financial system. The FSB aims to coordinate at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies in the interest of financial stability. It brings together national authorities responsible for financial stability in 24 countries and jurisdictions, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts.[7]

Basel Committee on Banking Supervision: The Basel Committee provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It seeks to do so by exchanging information on national supervisory issues, approaches and techniques, with a view to promoting common understanding. At times, the Committee uses this common understanding to develop guidelines and supervisory standards in areas where they are considered desirable. In this regard, the Committee is best known for its international standards on capital adequacy, the core principles for effective banking supervision, and the concordat on cross-border banking supervision.[8]

International Organization for Securities Commissions: IOSCO is recognised as the international standard-setter for securities markets. Its membership regulates more than 95% of the world's securities markets and it is the primary international cooperative forum for securities market regu-

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6 See http://www.g20.org/index.php/en/g20, last visited 02/07/2012.
7 See http://www.financialstabilityboard.org/about/overview.htm, last visited 02/07/2012.
8 See http://www.bis.org/bcbs/about.htm, last visited 02/07/2012.

latory agencies. IOSCO aims to ensure cooperation in developing, implementing and promoting adherence to internationally recognised and consistent standards of regulation, oversight and enforcement in order to protect investors, maintain fair, efficient and transparent markets, and seek to address systemic risks.[9]

International Association of Insurance Supervisors (IAIS): The IAIS is a sectoral standard-setter for insurance. The IAIS represents insurance regulators and supervisors of some 190 jurisdictions in nearly 140 countries, constituting 97% of the world's insurance premiums. It also has more than 120 observers. Its objectives are to promote effective and globally consistent supervision of the insurance industry in order to develop and maintain fair, safe and stable insurance markets for the benefit and protection of policyholders; and to contribute to global financial stability.[10]

The Financial Action Task Force (FATF): The FATF is an intergovernmental body established in 1989 by the Ministers of its Member jurisdictions. The objectives of the FATF are to set standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system. The FATF has developed a series of Recommendations that are recognised as the international standards for combating of money laundering and of the financing of terrorism and proliferation of weapons of mass destruction.[11]

The Committee on Payment and Settlement Systems (CPSS): The CPSS is a standard setting body for payment, clearing and securities settlement systems. The CPSS contributes to strengthening the financial market infrastructure through promoting sound and efficient payment, clearing and settlement systems. It also serves as a forum for central banks to monitor and analyse developments in domestic payment, clearing and settlement systems as well as in cross-border and multicurrency settlement schemes.[12]

Organization for Economic Co-operation and Development (OECD): Although the OECD is a hard law organization with a broad mandate, its role in financial regulation is limited. The mission of the OECD is to promote policies that will improve the economic and social well-being of peo-

[9] See http://www.iosco.org/about/, last visited 02/07/2012.
[10] See http://www.iaisweb.org/, last visited 02/07/2012.
[11] See http://www.fatf-gafi.org/pages/aboutus/, last visited 02/07/2012.
[12] See http://www.bis.org/cpss/index.htm, last visited 02/07/2012.

ple around the world. The OECD provides a forum in which governments can work together to share experiences and seek solutions to common problems. The OECD sets international standards on a wide range of things, from agriculture and tax to the safety of chemicals.[13]

International Association of Deposit Insurers (IADI): The IADI was formed in May 2002 to enhance the effectiveness of deposit insurance systems by promoting guidance and international cooperation. Members of IADI conduct research and produce guidance for the benefit of those countries seeking to establish or improve a deposit insurance system. Members also share their knowledge and expertise through participation in international conferences and other forums. IADI currently represents 64 deposit insurers from 63 jurisdictions.[14]

International Monetary Fund: The IMF is an organization of 188 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world. It promotes international monetary cooperation and exchange rate stability, facilitates the balanced growth of international trade, and provides resources to help members in balance of payments difficulties or to assist with poverty reduction. Through its economic surveillance, the IMF keeps track of the economic health of its member countries, alerting them to risks on the horizon and providing policy advice. It also lends to countries in difficulty, and provides technical assistance and training to help countries improve economic management.[15] Together with the World Bank, the IMF plays an important role in monitoring compliance with international financial standards.

The World Bank: The World Bank is like a cooperative in which 188 member countries are shareholders. It is an important source of financial and technical assistance to developing countries around the world. It helps governments in developing countries reduce poverty by providing them with necessary funding and technical expertise they need for a wide range of projects, such as education, health, infrastructure, communications, and government reforms and so on.[16]

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13 See http://www.oecd.org/about/, last visited 02/07/2012.
14 See http://www.iadi.org/, last visited 02/07/2012.
15 See http://www.imf.org/external/about/overview.htm, last visited 02/07/2012.
16 See http://www.worldbank.org/, last visited 02/07/2012.

C) Some Examples of International Financial Standards

As mentioned above, international financial standards and principles have been developed by international financial standard-setters throughout the years. Though these standards cover broad areas of financial relationships, it is necessary to explain some of the most famous international financial standards.

The Basel Committee, among other regulatory and supervisory issues, have been intensively dealing with the solvency of banks, and proposed rules on the banks' capital requirements. In 1988, Basel Committee introduced a new capital adequacy framework, known as the Basel I Capital Accord, which required that a bank's capital equals at least 8 percent of its risk-weighted assets.[17] The framework has been widely implemented around the world. Then, in 2004, the Committee issued a more sophisticated new capital framework, Basel II, based on the three pillars: minimum capital requirements, supervisory review, and market discipline.[18]

The Basel Committee's 'Core Principles for Effective Banking Supervision' have helped countries to assess their supervisory systems and identify areas for improvement. Core Principles document was originally issued in 1997 and revised in 2006. In response to the recent financial crisis, the Basel Committee announced its plan to review the Core Principles as part of its ongoing work to strengthen supervisory practices worldwide. The Basel Committee issued for consultation its revised 'Core Principles for Effective Banking Supervision' in December 2011, which updates the Core Principles and the associated Core Principles Methodology and merges the two documents into a single comprehensive document.[19]

IOSCO's revised Objectives and Principles of Securities Regulation contain 38 Principles of securities regulation, which are based upon three objectives of securities regulation: protecting investors; ensuring that markets are fair, efficient and transparent; and reducing systemic risk. It is noted that 38 Principles need to be practically implemented under the relevant legal

17 See Basel Committee on Banking Supervision, 'International Convergence of Capital Measurement and Capital Standards' (July 1988) (available at http://www.bis.org/publ/bcbs04a.pdf, last visited 02/07/2012).

18 Basel Committee on Banking Supervision, 'International Convergence of Capital Measurement and Capital Standards: A Revised Framework' (June 2004) (available at http://www.bis.org/publ/bcbs107.pdf, last visited 02/07/2012).

19 See Basel Committee on Banking Supervision, 'Core Principles for Effective Banking Supervision: Consultative Document' (December 2011) (available at http://www.bis.org/publ/bcbs213.pdf, last visited 02/07/2012).

framework to achieve these objectives.[20] IOSCO's revised Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (MMoU) sets an international benchmark for cross-border co-operation critical to combating violations of securities and derivatives laws. The MMoU represents a common understanding amongst its signatories about how they will consult, cooperate, and exchange information for securities regulatory enforcement purposes.[21] IOSCO's both initiatives have been endorsed and implemented by many countries.

The FATF's main legislative achievement is Forty Recommendations, a set of principles for action against money laundering. The original FATF Forty Recommendations were drawn up in 1990 as an initiative to combat the misuse of financial systems by persons laundering drug money. In October 2001, the FATF expanded its mandate to deal with the issue of the funding of terrorist acts and terrorist organisations, and took the important step of creating the Eight (later expanded to Nine) Special Recommendations on Terrorist Financing. Then, they have been integrated in Forty Recommendations in 2012. The FATF Recommendations have been endorsed by over 180 countries. The FATF Recommendations set out a comprehensive and consistent framework of measures which countries should implement in order to combat money laundering and terrorist financing, as well as the financing of proliferation of weapons of mass destruction.[22]

In regard to international financial regulation, the OECD's most important standards are its Principles of Corporate Governance, which were first issued in 1999, and then revised in 2004. This work establishes standards and guidelines for countries to devise effective corporate governance frameworks, including the rights, roles and responsibilities of stakeholders, shareholders, and company management. The OECD Principles are one of the 12 key standards for international financial stability of the Financial

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20 For revised version of the document see International Organization of Securities Commissions, 'Objectives and Principles of Securities Regulation' (June 2010) (available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf, last visited 02/07/2012).

21 International Organization of Securities Commissions, 'Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information' (May 2012) (available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD386.pdf, last visited 02/07/2012).

22 The Financial Action Task Force 'International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation: The FATF Recommendations' (February 2012) (available at http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF%20Recommendations%20(approved%20February%202012)%20reprint%20May%202012%20web%20version.pdf, last visited 02/07/2012).

Stability Board, and form the basis for the corporate governance component of the Report on the Observance of Standards and Codes.[23]

D) Implementation and Enforcement

Implementation and enforcement aspect of international financial law is a thorny issue. Since international financial standards are mostly agreed among the national regulators and supervisors, their implementation requires necessary changes in the domestic law. However, as said above, the standards and principles issued by international organizations are essentially soft law, which are not legally binding, but are implemented voluntarily. Moreover, there is no formal enforcement mechanism for international financial law. In the absence of formal enforcement mechanisms for the implementation of international financial standards, some other concerns, e.g., market mechanisms and institutional sanctions have become the main force to ensure implementation of international standards.

Reputation may be the first concern to implement relevant international financial standards. A state's aim to give a clear message to market and other states that it observes relevant international standards can be a strong incentive for the implementation. Regulatory competition can be another reason to implement the latest international standards in order to ensure the competitiveness of the domestic financial markets. Market discipline is another factor for compliance of international standards, through which the cost of capital for firms may be reduced. Market discipline can be ensured through various instruments, such as credit risk weightings, private ratings, borrowing spreads, differentiated interest rates. Finally, international standard-setters and other organizations may exert institutional discipline by developing some policies and measures to promote implementation of international financial standards. The IMF and the World Bank's financial assistance conditionality, name and shame practices implemented by the FATF, and capital market sanctions are the main examples of institutional disciplines.[24]

Up until now, aforementioned mechanisms have performed as enforcement and sanctions for the implementation of international financial law instruments. Thus, most of the international financial standards have widely been implemented across the world.

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[23] Organisation for Economic Co-Operation and Development, 'OECD Principles of Corporate Governance' (2004) (available at http://www.oecd.org/daf/corporateaffairs/corporategovernanceprinciples/31557724.pdf, last visited 02/07/2012).

[24] For further information see Lastra, (n 2), 465-471; Brummer, (n 3), 138-157.

III. Regulatory Reforms after the Crisis

After the recent financial crisis, many countries including the US were motivated to reform their domestic regulatory systems as well as the international regulatory system. During the crisis, it was realized that there were significant problems in the functioning of the financial markets as well as financial institutions. G20 issued several statements in which it is agreed that necessary steps should be taken to strengthen the global financial regulation and supervision.

Under this section, some international regulatory reforms as well as the reforms in the US and EU will be explained. There are at least two reasons to justify the particular attention given to the reforms in the US and EU. First, these two jurisdictions have become two main sources of financial law, and have potential to affect regulatory strategies across the world. Second, as elaborated below, the reforms in these two jurisdictions are parallel with international regulatory efforts.

A) International Standards

There have been incredible amount of regulatory proposals at the international level after the recent financial crisis. Some of those proposals are mentioned below.

The main international regulatory reform after the crisis is the introduction of a broader bank capital reform. Basel III process was completed in 2010 and revised in June 2011, but its full implementation will take some time (2019). Under Basel III, banks are required to hold more capital including conservation buffer. Moreover, banks must satisfy a leverage ratio measuring the bank's degree of debt. Basel III, in addition to enhanced minimum capital requirements, also introduces two liquidity ratios in order to prevent liquidity crisis in the future: Liquidity coverage ratio and net stable funding ratio.[25]

Shadow banking system is seen as one of the main reasons for recent financial crisis. Indeed, the shadow banking system can become a source of systemic risk, both directly and through its interconnectedness with the regular banking system. The FSB was asked to define the context of shadow banking system, and to set out approaches for effective monitoring of

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[25] Basel Committee on Banking Supervision, 'Basel III: A global regulatory framework for more resilient banks and banking systems' (December 2010 (rev June 2011)) (available at http://www.bis.org/publ/bcbs189.pdf, last visited 02/07/2012).

the shadow banking system, and to explore additional regulatory measures to address the systemic risk and arbitrage concerns posed by the shadow banking system. In regard to these issues, the FSB's report outlines the overall approach being taken to strengthen the oversight and regulation of the shadow banking system, and sets out the details of the proposed recommendations for intensifying monitoring and enhancing regulation.[26]

Regulation and supervision of systemically important financial institutions have become an important policy concern after the recent financial crisis. The FSB's SIFI report sets out recommendations for making the supervision of financial institutions more intense, effective and reliable. While the recommendations are primarily aimed at making SIFIs less susceptible to failure, there are also lessons for the supervision of financial institutions more generally.[27]

There have also been significant efforts to regulate hedge funds. IOSCO amended its objectives and principles of securities regulation to include a statement that regulation should ensure that hedge funds and/or hedge funds managers/advisers are subject to appropriate oversight.[28] The IOSCO Technical Committee published a report which recommends six high-level principles on the regulation of hedge funds.[29]

The recent financial crisis has shown the weaknesses of the over-the-counter (OTC) derivatives markets which have potential to become a source of systemic risk due to the interconnectedness of OTC derivatives market participants and the limited transparency of counterparty relationships. Thus, the international regulatory community has aimed to ensure that all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties (CCP). Subsequently, the FSB issued 21 recommendations in the report on Implementing OTC Derivatives Market Reforms, which address practical issues that authorities may encounter in the stan-

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26 See Financial Stability Board, 'Shadow Banking: Strengthening Oversight and Regulation' (27 October 2011) (available at http://www.financialstabilityboard.org/publications/r_111027a.pdf, last visited 02/07/2012).

27 See Financial Stability Board, 'Intensity and Effectiveness of SIFI Supervision: Recommendations for enhanced supervision' (2 November 2010) (available at http://www.financialstabilityboard.org/publications/r_101101.pdf, last visited 02/07/2012).

28 See above note 20.

29 For the details see IOSCO Technical Committee, 'Hedge Funds Oversight' (June 2009) (available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD293.pdf, last visited 02/07/2012).

dardisation, central clearing, exchange or electronic platform trading, and reporting of OTC derivatives transactions to trade repositories.[30]

The recent financial crisis illustrated that lack of proper crisis management and resolution frameworks for internationally active financial institutions left two options for the authorities: first massive bail-out of financial institutions to ensure financial stability at the expense of public money and moral hazard, and second catastrophic failures and disorderly resolution. The international political will under the umbrella of the G20 urged the international standard-setters to develop an international framework for orderly resolution of cross-border financial institutions. Since then, international financial organizations have spent significant efforts on the subject matter; as a result, three key papers on cross-border bank resolution have been issued by the Basel Committee, the IMF and the FSB.[31]

Executive compensation issue at the financial institutions has become a phenomenon during the recent financial crisis, and is seen one factor among many that contributed to the financial crisis. In 2009, the Financial Stability Board issued a report[32] to respond to the call by the G20 Finance Ministers and Governors to submit to the Pittsburgh Summit detailed specific proposals on corporate governance reforms, global standards on pay structure and greater disclosure and transparency, to strengthen adherence to the FSB Principles for Sound Compensation Practices issued in April 2009. In parallel to this development, the Basel Committee produced an assessment methodology to guide supervisors in reviewing individual firms' compensation practices and assessing their compliance with the FSB Principles for Sound Compensation Practices and their implementation standards.[33]

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[30] Financial Stability Board, 'Implementing OTC Derivatives Market Reforms' (25 October 2010) (available at http://www.financialstabilityboard.org/publications/r_101025.pdf, last visited 02/07/2012).

[31] Basel Committee on Banking Supervision, 'Report and Recommendations of the Cross-border Bank Resolution Group' (March 2010) (available at http://www.bis.org/publ/bcbs169.pdf, last visited 17/05/2012); International Monetary Fund, 'Resolution of Cross-Border Banks-A Proposed Framework for Enhanced Coordination' (June 11, 2010) (available at http://www.imf.org/external/np/pp/eng/2010/061110.pdf, last visited 17/05/2012); Financial Stability Board, 'Key Attributes of Effective Resolution Regimes for Financial Institutions' (November 2011) (available at http://www.financialstabilityboard.org/publications/r_111104cc.pdf, last visited 17/05/2012).

[32] See Financial Stability Board, 'FSB Principles for Sound Compensation Practices: Implementation Standards' (25 September 2009) (available at http://www.financialstabilityboard.org/publications/r_090925c.pdf, last visited 02/07/2012).

[33] Basel Committee on Banking Supervision, 'Compensation Principles and Standards Assessment Methodology' (January 2010) (available at http://www.bis.org/publ/bcbs166.pdf, last visited 02/07/2012).

Credit rating agencies (CRA) were among the most discussed actors of the recent financial crisis and there have been some recommendations on their oversights. IOSCO's objectives and principles were amended to include a principle noting that credit rating agencies should be subject to adequate levels of oversight. Moreover, the regulatory system should ensure that credit rating agencies whose ratings are used for regulatory purposes are subject to registration and ongoing supervision.[34] In addition to this, the FSB published some principles to reduce reliance on CRA ratings in standards, laws and regulations. The principles aim to catalyse a significant change in existing practices, to end mechanistic reliance by market participants, and to establish stronger internal credit risk assessment practices instead.[35]

B) Reforms in the United States of America

The recent financial crisis was also the main incentive behind the major regulatory reforms conducted in the US. In this regard, Dodd-Frank Wall Street Reform and Consumer Protection Act[36] is a massive piece of legislation that includes many provisions regarding the financial markets, institutions and instruments. Some of the new issues that the Act regulates are generally parallel with international concerns.

Among others, the Act transfers the functions and responsibilities of the Office of Thrift Supervision to the Office of the Comptroller of the Currency, the Federal Reserve, and the Federal Deposit Insurance Corporation. It establishes a Financial Stability Oversight Council to monitor systemic risks and to identify nonbank financial companies as systemically significant and subjects them to Fed supervision, and sets up a Consumer Financial Protection Bureau within the Federal Reserve, charged with administering the consumer financial protection laws. The Act requires the Federal Reserve to develop enhanced prudential standards for certain bank holding companies and systemically important nonbank financial firms, and allows the orderly liquidation of failing systemically significant bank holding companies and nonbank financial firms. It includes "Volcker Rule" provisions that (subject to exceptions) prohibit banking entities from engaging in pro-

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[34] See above note 20.

[35] See Financial Stability Board, 'Principles for Reducing Reliance on CRA Ratings' (27 October 2010) (available at http://www.financialstabilityboard.org/publications/r_101027.pdf, last visited 02/07/2012).

[36] The text of Act is available at http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf, last visited 02/07/2012.

prietary trading, investing in, or sponsoring, hedge funds or private equity funds. In terms of securities regulation, the Act imposes new mortgage lending standards and new standards with respect to securitization of pools of financial instruments, requires hedge and private equity fund advisers to register with the Securities and Exchange Commission (SEC), subjecting them to SEC inspection and examination, imposes disclosure requirements on credit rating agencies, with SEC registration and supervision, and brings greater transparency to, and regulation of, the OTC derivatives market.

C) European Union

At the European level, there have also been significant regulatory reform projects, again mostly in line with the international developments. Some reforms have been concluded whereas some others are still pending. The reforms at the EU level are generally related to new architecture for financial supervision, stability and governance of financial institutions, efficiency, integrity, liquidity and transparency of markets, and protection of consumers and investors, some of which are elaborated below.[37]

In September 2009, the Commission brought forward proposals to replace the EU's existing supervisory architecture with a European System of Financial Supervisors (ESFS), consisting of three European Supervisory Authorities-a European Banking Authority, a European Securities and Markets Authority (ESMA), and a European Insurance and Occupational Pensions Authority. They will help restore confidence; contribute to the development of a single rulebook; solve the problems with cross-border firms; and prevent the build-up of risks that threaten the stability of the overall financial system. Three European Supervisory Authorities (ESAs) and a European Systemic Risk Board (ESRB) were established as from January 2011 to replace the former supervisory committees.

In July 2011, the Capital Requirements Directive (CRD) was revised in order to implement the Basel III agreement, which significantly increases the levels of capital which banks and investment firms must hold to cover their risks. In this regard, the Commission adopted a legislative package to strengthen the regulation of the banking sector. The proposal replaces the current Capital Requirements Directives (2006/48 and 2006/49) with a Direc-

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[37] Detailed information regarding the regulatory reforms, including pending proposals relating to the EU financial markets can be found at the Internal Market's website. See http://ec.europa.eu/internal_market/top_layer/financial_capital/index_en.htm, last visited 02/07/2012.

tive and a Regulation, and constitutes another major step towards creating a sounder and safer financial system. The directive governs the access to deposit-taking activities, while the regulation establishes the prudential requirements institutions need to respect.

In November 2011, Regulation on Credit Rating Agencies tackled further risks related to the functioning of the rating business, such as the "issuer-pays" model, the overreliance on ratings, the lack of competition in the sector, and the specificities of sovereign debt. A new EU regulatory regime imposed tough rules on CRAs and made them subject to EU-level supervision by ESMA.

The Commission adopted a Directive on Alternative Investment Fund Managers (AIFMs) with the objective to create a comprehensive and effective regulatory and supervisory framework for AIFMs at the European level. The Directive will provide robust and harmonised regulatory standards for all AIFMs within scope, and enhance the transparency of the activities of AIFMs. This will enable Member States to improve the macro-prudential oversight of the sector and to take coordinated action as necessary to ensure the proper functioning of financial markets.

There is currently no EU framework for managing crises in the banking sector and the recent crisis has clearly shown that the lack of an EU regime hampers the ability of governments to deal with problems in both national and cross-border banks. In the aftermath of the recent financial crisis, the Commission involved itself in the process of consultation and elaboration of proposals for the resolution of banks and financial institutions. Eventually, the Commission has proposed the Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EC and Regulation (EU) No 1093/2010.

In October 2011, the Commission adopted a proposal for a Regulation on Market Abuse to update and strengthen the existing framework to ensure market integrity and investor protection provided by the Market Abuse Directive and a proposal for a Directive on Criminal Sanctions for Market Abuse that requires Member States to take the necessary measures to ensure that the criminal offences of insider dealing and market manipulation are subject to criminal sanctions.

The European Markets Infrastructure Regulation on Over-The-Counter Derivatives Markets (EMIR) was proposed in autumn 2010, implementing the G20 commitment that standardised OTC derivative transactions be cleared via central counterparties. The proposal's objectives are to increase transparency in the OTC derivatives market and to make it safer by reducing counterparty credit risk and operational risk. If a party to a transaction fails in mid-transaction, the existence of a CCP would mitigate the risk and uncertainty as to whether the transaction will be completed. A further obligation for OTC derivatives to be registered in trade repositories, with access for supervisors in the EU, will provide a better overview of exposures and will help detecting any potential problems, such as accumulation of risk, early on. Political agreement on the proposals between the Council and Parliament was reached in trilogue on 9 February 2012. EMIR is expected to enter into force at the end of 2012.

A Regulation regarding Short Selling and Credit Default Swaps (CDSs), adopted in 2011, will increase transparency via a requirement for notification or disclosure of significant short positions relating to shares and sovereign debt, impose restrictions on short sales through a locate requirement, prohibit naked CDSs on EU sovereign debt instruments, and enhance competent authorities' and ESMA's intervention powers. This will enable supervisors to reduce the risks from short selling and CDSs and ensure a common regulatory approach across the EU.

IV. Opportunities and Challenges for Emerging Market Economies

This massive amount of regulatory reforms conducted at the national and international level will affect emerging market economies as well to a certain extent. This basically means opportunities and challenges for emerging markets.

A) Opportunities

New regulations will cause three 'c': complexity, cost, and competitiveness problems in the developed financial markets. All these national and international regulatory reforms will increase the cost of operation in the developed financial markets, and will definitely lead to complexity and compliance problems for financial sector players.

For instance, one recent study suggested that financial services firms were being hit with 60 rule changes every working day.[38] In addition to this, the world's 29 largest global banks will need to raise an additional $566bn

[38] See Masters, Brooke, 'Regulation 'pushing up financial firms' costs", Financial Times, May 13, 2012.

in new capital or shed about $5.5tn in assets by 2018 to meet the new tougher Basel III bank capital standards, a new study by Fitch Ratings has found.[39] Moreover, there is a risk that developed countries will lose their competitiveness across the globe due to the aforesaid cost and complexity problems.

This situation presents some opportunities to emerging market economies and their financial firms, which are neither limited nor exclusive.

First of all, given the current financial problems in the financial firms that operate in the western economies, there are some opportunities for emerging markets financial firms to acquire these firms and expand their operations to the developed countries.

However, this is not really easy. For instance, when Industrial & Commercial Bank of China (ICBC) received approval in May 2012 to buy a US bank, it was the first time US regulators had allowed a Chinese institution to acquire control of a US bank. ICBC, the world's largest bank by market value and also the most profitable, bought 80 per cent of Bank of East Asia's US subsidiary, which has just $780m in assets. The delay in US approval for ICBC's acquisition of the Bank of East Asia's American operations arose from close regulatory scrutiny. The Federal Reserve, which had previously blocked an acquisition by China Minsheng Bank of US lender UCB, ruled that Chinese regulators now met its standard for "comprehensive, consolidated supervision".[40]

Second, due to cost and compliance problems, some firms will attempt to move their business to emerging markets where regulation is relatively lax. So, the financial institutions may move their business from more developed world to emerging market economies.

The third opportunity is also related to the second one, meaning, after the recent financial crisis, it will be possible to see the rise of regional financial centres. For instance, Istanbul Financial Centre Project in Turkey will lead Turkey to become a regional financial hub in a couple of years provided that it is implemented successfully.

However, it is vital and imperative to establish basic legal and technical infrastructures to welcome these developments and attract more investment in the financial sector.

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39 See Masters, Brooke, 'Big banks need extra $566bn, says Fitch', Financial Times, May 17, 2012.

40 See Rabinovitch, Simon, 'Slow march of Chinese banks' expansion' Financial Times, May 10, 2012.

B) Challenges

These regulatory reform waves at the international level will eventually affect emerging economies. As said earlier, market mechanisms and institutional sanctions have played an important role to require emerging market economies to observe relevant international financial standards. Thus, emerging market economies will be required to fully implement the latest international financial standards developed after the recent financial crisis.

From emerging markets' point of view, there are some problems associated with international financial law. These problems are also the source of challenges for emerging markets. I will look at those problems from emerging markets' point of view. Otherwise, there are some other problems regarding the regulation itself.

From emerging markets' point of view, the main institutional problems in connection with the international financial standards are the legitimacy and accountability. Legitimacy is mostly related to the participating the rule-making process, while accountability is relating to the process itself. In terms of legitimacy, most international standard-setters are criticised for being dominated by more developed or western countries. This structure clearly excludes some countries from the rule-making process. In regard to accountability, the rule-making process of international organizations is perceived to be less transparent. These two problems have the potential to challenge the credibility of international financial standards, whereby lead to country ownership problem.[41]

However, the recent financial crisis has shifted the paradigms in favour of emerging market economies, and led to certain changes in the international financial architecture to reduce the concerns regarding legitimacy and accountability issues. First of all, instead of G7, G20 has become the leading forum for economic policymaking. In parallel to this, second, the number of countries participating in the standard setting process has been expanded. Many emerging market economies, including China, Brazil, South Africa, India, and Turkey have found their places in standard setting bodies such as the FSB, Basel Committee, and in a different level at the IOSCO, and other specific standard setting bodies. However, in some traditional international organizations such as the World Bank and the IMF, certain countries have greater representation than others, despite the changes in the quotas at the IMF. In regard to accountability, international organizations have

[41] See Lastra, (n 2), 464-465; Brummer, (n 3), 177-192.

moved towards greater transparency in terms of rule-making process.[42] These are very welcomed developments regarding legitimacy and accountability of the international organizations. However, there are still representation problems in the international standard setting bodies in connection with the number of representatives and participation to the technical committees.

Although there have been significant efforts to eliminate institutional problems regarding the international financial law, the structural problems have remained intact. Most of the international financial standards develop one-size-fits-all solutions, which do not necessarily reflect the differences between financial markets in the developed and emerging economies. There are certain differences between these two types of markets, including differences in the market structure such as bank-dominated and less competitive financial sectors in the latter, in legal culture, and in the nature and understanding of risks in the financial markets. The size of the markets is also an important consideration. Thus, some of the international financial standards may be too complex and sophisticated for emerging market economies.

It is not fair to argue that all those international financial standards are not fit for emerging market economies, and should not be implemented by them. Indeed, some international standards such as Basel I, IOSCO's objectives and principles of securities regulation, FATF's recommendations on money laundering and financing terrorism have been widely implemented. However, some others may not be suitable for the needs of emerging market economies, and if they are implemented, the emerging markets will never be able to compete with developed countries.

V. Conclusion: The Way Forward

The aforementioned issues require emerging market economies to conduct necessary reform projects to eliminate the challenges and exercise the opportunities.

First of all, the rule of law is still missing in many emerging market economies. As Adam Smith mentioned two centuries ago, a proper legal system is an important pre-condition for the development of economic activities.[43] Sound legal structures are important for the proper functioning of

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[42] See Brummer, (n 3), 192-196.

[43] "Commerce and manufactures can seldom flourish in any state in which there is not a certain degree of confidence in the justice of government." See Smith, Adam, Wealth of Nations, (1776).

markets and for the success of economic reform. We need the rule of law, i.e., a stable legal regime, efficient and swift judicial system, transparency and accountability in the emerging market economies.

Second, emerging market economies would never gain a competitive advantage against the mature economies by playing the same rules, since there is an incredible information gap between these two types of economies. Financial markets in the developed economies are characterized by certain features such as the existence of highly skilled individuals, sophisticated financial institutions, financial instruments and risk management techniques. In order to compete with those markets and institutions, emerging markets should develop their own regulatory strategies. Basically, legal transplantation would never help emerging economies to be a world player. This last concern requires developing original regulatory strategies to gain competitiveness across the world, not the copy-paste regulatory approach.

In terms of copy-paste regulatory approach, let's take the example of executive compensation practices which have led to a great debate after the recent financial crisis. Many countries have attempted to limit the excessive compensation packages provided to the senior managers of the financial companies. Essentially, there is nothing wrong with compensation packages. This basically refers to the more a company makes profit the more managers earn. So, it is incentive compatible, thanks to which there have been significant growth and expansion of business over the years. The problem is the abuse of this basic principle where the managers focus on short-term profitability to ensure their bonuses while neglecting the company's longer-term prospects. Therefore, it makes sense to limit this kind of practices in the western countries. However, I do not believe that emerging markets have the same problem, nor they need the same rules. On the contrary, the new rules in the developed countries can present an opportunity for emerging market economies to attract highly-skilled employees. Second, it is necessary to follow the same stages economically before having those rules in place. That said, the managers need to be incentivised to expand their business across the globe. This will only be possible through generous remuneration packages so as to encourage managers to think beyond the current business strategies and borders.

Third, emerging markets should develop economic relations among themselves. They still use major financial centres such as London and New York as middlemen to do financial business among themselves. I believe it is time to start enhancing direct financial activities among the emerging markets.

Fourth, emerging market economies should act together, and unify their voice in the international arena, especially in the rule-making process in order to protect their own interests.

Last but not least, they should seek to figure out alternative international financial regulatory standards suitable to the structure of their financial markets. This can be realized through the establishment of new regional groups or standard-setters to identify standards and best practices suitable to the needs of emerging market economies and their financial market participants.