Journal of European Public Policy

ISSN: 1350-1763 (Print) 1466-4429 (Online) Journal homepage: http://www.tandfonline.com/loi/rjpp20

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Journal of European Public Policy, 2014
Vol. 21, No. 3, 430–452, http://dx.doi.org/10.1080/13501763.2014.882968

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ABSTRACT Soft law promulgated by transnational networks is one of the hallmarks of governance in global finance. Standard accounts alternatively view such governance as a fast and flexible solution to transnational problems or weakly institutionalized club standards epiphenomenal to great power interests. We argue that dominant perspectives' view of soft law is misguided, as soft law in global finance cannot be understood in isolation from domestic law. Viewing soft law through the prism of multilevel governance highlights the role European integration in particular plays in 'hardening' soft law provisions, thereby shaping the global diffusion of such standards. As soft law becomes embedded in domestic law, its certainty and durability are enhanced while at the same time its flexibility is reduced. Case studies of the diffusion of international accounting standards and close-out netting rules for over-the-counter derivatives provide empirical support for the importance of domestic law in the global diffusion of soft law.

KEY WORDS Accounting standards; financial regulation; global governance; over-the-counter derivatives; soft law.

The global regulation of finance is marked by its reliance on soft law rules promulgated by non-treaty-based networks (Brummer 2011; Zaring 1998). Fairly informal bodies, such as the Basel Committee for Banking Supervision or the International Accounting Standards Board, shape market competition through capital adequacy rules, accounting standards, and other technical and substantive rules (Alexander *et al*. 2006; Davies and Green 2008; Oatley and Nabors 1998; Porter 2005a; Tarullo 2008). On the one hand, such standards have been championed as a new fast and flexible solution to transnational financial governance (Slaughter 2004; Zaring 1998). On the other hand, power-based theories have characterized them as epiphenomenal to great power interests with limited application to politically charged issues (Drezner 2007).

We argue that dominant perspectives' view of the role of soft law in global finance is misguided, as soft law in global finance cannot be understood in isolation from domestic law. We advocate viewing the role of soft law through the prism of multilevel governance and argue that European integration in particular promotes soft law diffusion (Hooghe and Marks 2003). Across multiple issues in global finance, the European Union (EU) acts as a legalization mechanism that transforms soft law from informal transnational best practice into embedded rules backed by domestic law (Caporaso and Tarrow 2009; Goldstein *et al.* 2000).

The decision by the EU, or a significant number of member states, to adopt and incorporate such standards into law alters global diffusion dynamics. Once the EU, or a significant number of member states, have legally committed to a set of soft law standards, these standards are no longer simply informal institutions or instances of private global governance. Rather, they have been 'hardened' and are henceforth backed by domestic law. Such hardening alters the incentives of EU actors to support and promote the global regime. At the same time, it alters the attractiveness of the regime to other jurisdictions. This is because European commitment frequently constitutes a tipping point, signaling to other jurisdictions that a proposed private standard will likely diffuse widely. While national or regional regulatory incorporation boosts certainty in the private regime, the traditional flexibility ascribed to such regimes is reduced, as they become entangled in the domestic regulatory, legislative and legal structures of large markets (Shaffer and Pollack 2009). By incorporating analytically the role of domestic law, our approach leads us to question the flexibility of such standards emphasized in both the private actor governance and power-based approaches. At the same time, it suggests much more predictability and durability. This contribution, then, focuses on the way the EU – advertently and at times inadvertently – transforms and institutionalizes informal voluntary best practices into domestically embedded legal rules, thereby shaping global diffusion dynamics.

To demonstrate the way in which the EU acts as a hardening agent for international soft law, we examine two critical cases of global financial governance: international accounting standards and close-out netting rules for over-the-counter derivatives. Accounting standards is often held up as a prime example of private transnational governance. While the important role of private actors in shaping global standards is undeniable, we show how EU endorsement of international financial reporting standards (IFRS) and their embedding within EU law gave private efforts a tremendous boost and transformed a mere voluntary standards project into the kernel of global regulation. The derivatives case takes the argument a step further by demonstrating the important role that national legislatures continue to play and highlights how ongoing EU-led financial re-regulation efforts create an opportunity structure for transnational policy entrepreneurs. Taken together, the cases offer the empirical context for a robust plausibility probe that explores the effect of soft law hardening via supranational imposition and national embedding for global diffusion.

The contribution makes several important contributions to the literature on the EU's role in global governance. It couples two dynamics that increasingly receive attention in research on international regulation and yet have been discussed largely separately: the EU as a global regulatory actor and the rise of international soft law in finance (Bach and Newman 2007; Brummer 2011; Büthe and Mattli 2011; Mügge 2011; Posner 2009a; Underhill and Zhang 2008). Moreover, it highlights the links between domestic rules and global standards, broadening the discussion of soft law and private governance (Bach and Newman 2010; Helleiner and Pagliari 2011; Kaczmarek and Newman 2011; Putnam 2009). Finally, it helps resolve an important empirical puzzle concerning the widespread use of soft law: the remarkable resilience of many international soft law standards despite their demonstrably shallow institutionalization at the global level.

SOFT LAW IN GLOBAL FINANCIAL REGULATION: MORE THAN SECOND BEST?

The global regulation of finance relies on a patchwork of informal regulatory networks comprised of public and private actors. Bodies such as the International Organization of Securities Commissions (IOSCO), the Basel Committee on Banking Regulation, the International Association of Insurance Supervisor (IAIS), the International Accounting Standards Board (IASB), and the International Derivatives and Swaps Association (IDSA) promulgate best practices and standards (Alexander *et al.* 2006; Davies and Green 2008; Underhill and Zhang 2008). This soft law regime is striking in its thin degree of institutionalization and widespread reliance on voluntary compliance (Brummer 2011; Porter 2005a).[1] Nevertheless, such soft law standards have diffused widely and are shaping market dynamics. What explains the adoption of standards promulgated by such informal institutions is one of the critical questions in current research on global governance.

Extant research in the institutionalist tradition commonly explains these bodies' influence by focusing on the interaction of technical knowledge held by private actors and the disciplining effects of the market. According to these studies, private actors with deep sector expertise enjoy broad legitimacy to shape transnational rules and market participants largely adopt these standards because of competitive pressures (Büthe and Mattli 2011; Mattli and Büthe 2005; Perry and Nolke 2006).

An alternative, power-based literature offers a very different perspective on the spread of network-based standards. Viewing such standards as club goods, authors in this tradition argue that their adoption by large and powerful markets create trading up pressure (Drezner 2007; Posner 2009a; Simmons 2001). If the United States (US) and EU have adopted a particular capital adequacy standard, for example, banks that fall below it risk exclusion from those markets, as well as the reputational cost of failing to comply with 'best practice' (Kapstein 1992; Oatley and Nabors 1998).

These perspectives explicitly or implicitly take to heart the pervasive view of soft law as under-institutionalized (Abbott and Snidal 2000; Kahler and Lake 2009; Vabulas and Snidal 2013). Without treaty-based organizations to guarantee compliance and implementation, advocates of private actor governance must invoke market discipline to explain soft law adoption, while those viewing soft law primarily as club standards invoke the whims of great powers for their causal constructs. In short, according to these perspectives, soft law represents a regulatory 'second best' that lacks the credible commitment needed in international co-operation. While soft law may serve as a fast and flexible response to co-ordination problems when there are few distributional or enforcement problems, conventional wisdom holds that it faces the pernicious challenge of shirking or cherry-picking. Owing to its lack of legalization, in which case legal actors and institutions would create pressure for convergence, soft law is characterized by considerable uncertainty (Goldstein *et al.* 2000; Shaffer and Pollack 2009). This uncertainty, in turn, should undermine the spread and diffusion of such rules.

In addition, the analytic attention on private actors or powerful states has produced a series of narrow 'setting standards'-debates that has focused on who exerts the most influence over agendas (Bach and Newman 2007; Mügge 2011; Perry and Nolke 2006; Posner 2009a; Quaglia 2014; Underhill and Zhang 2008). While such distributional trade-offs are important, not enough attention has been paid to how transnationally promulgated rules spread and why some reach critical mass of adopters and others do not. We believe that the scholarly debate has largely missed fundamental changes in the institutionalization of the global regime for finance that condition diffusion processes, specifically the way soft law standards are hardened through domestic law in leading jurisdictions.

To broaden the debate, we propose to place soft law dynamics within a multilevel governance framework in which these informal rules interact and are embedded within regional and national law. Owing to disciplinary boundaries within political science, international and domestic law are often kept separate, with International Relations (IR) scholars focusing primarily on treaty-based international law (Dunoff and Pollack 2012; Helleiner and Pagliari 2011). This silo approach hinders the tracing of causal processes across levels and domains. There are, of course, exceptions. Work on extraterritoriality and diffusion, for example, demonstrates the important and growing interdependencies of domestic law in global governance (Bach and Newman 2010; Kaczmarek and Newman 2011; Powell and Staton 2009; Putnam 2009; Raustiala 2002; Simmons and Elkins 2004; Zaring 2004).

In this contribution, we show not just how international soft law best practices become legally binding, domestically embedded rules (Eberlein and Newman 2008; Lavelle 2011; Singer 2007), but also the consequence of this legal incorporation for global governance. While such embedding by early adopters is a key step in the diffusion process, particularly if they are leading jurisdictions such as the US or EU, there is an important trade-off confronting the underlying soft law-promulgating bodies. First, domestic politics in early adopters will slow the speed of standards change in those jurisdictions. Second, powerful jurisdictions will seek to engage the governance of the private regime according to their preferences. As a result, once a set of private standards has been formally embedded domestically, it may become less flexible and amendable to change at the international level. Post-embedding, expert-driven agenda-setting must now confront the political realities of the domestic regulatory setting in leading jurisdictions (Barr and Miller 2006; Zaring 2004). Stakeholders become invested in the standard as regulators develop local rules to interpret and implement them. Similarly, even the most powerful jurisdictions cannot simply ignore their prior commitment to a nominally voluntary standard as domestic veto points and regulatory politics keep said commitment in check (Goldstein *et al.* 2000). As transnational soft law becomes embedded within national law, it is no longer epiphenomenal to state power or technical experts. In terms of institutionalization, after domestic embedding, the initially informal soft law standards enjoy much of the domestic certainty of ratified 'treaty-based' rules held up in existing literature as the non-plus-ultra of global governance (Goldstein *et al.* 2000).

When such domestic embedding occurs in leading markets, it has global spillover effects, which can alter the character of the global regulatory regime and promote adoption in other markets. First and most obvious, early adopters have every reason to proselytize their chosen soft law standard within cross-border expert networks in a traditional agenda-shaping fashion. This is because once a leading market has formally committed to a set of soft law standards, its regulators have an incentive to promote these rules to mitigate regulatory adjustment costs or competitive disadvantages for their firms. Failure to do so risks inefficient regulatory fragmentation if other leading markets choose competing rules or, even worse, costly lock-in (Büthe and Mattli 2011). To ward off standards fragmentation and Pareto-inefficient lock-in, leading domestic regulators frequently go beyond merely praising the merit of their adopted solution. They rely on extraterritorial provisions in domestic law to impose local rules on foreign firms (Farrell 2003; Kaczmarek and Newman 2011; Newman 2008). It is not simply the epiphenomenal decision by powerful states that alters the diffusion process, but, ironically, the binding nature of domestic law within them that spurs the global promotion of such rules. To put it another way, domestic law offers large markets the regulatory capacity necessary to enforce and promote the standard (Bach and Newman 2007; Newman 2008).

Equally important, the incorporation of informal rules and standards into the domestic law of large markets mitigates the uncertainty that frequently besets international soft law provisions (Shaffer and Pollack 2009). Domestic embedding is a credible and costly commitment that signals the viability of the standard to other jurisdictions. Once such standards become domestic rules and are subject to domestic veto points, typical domestic political dynamics kick in, which reduce the likelihood of sudden policy shift. To remain effective, transnational standard-setters must engage regulators from leading markets that have adopted their promulgated rules and create mechanism to incorporate their concerns. A mutual dependence emerges between the standard-setter and leading adopters (Richardson and Eberlein 2011). This prevents rapid or radical changes to the transnational standard, since transnational standard-setters know they cannot advance too far ahead of powerful domestic regulators or risk losing influence. The mutual dependence sends a costly signal to other jurisdictions regarding the predictability of the soft law regime.

We are particularly interested in the ways in which the EU has transformed the character of soft law in global finance and thereby promoted its adoption globally. The EU, however, is not the only hardening agent for international soft law. A potent example of the US giving a private sector solution global reach by formally embedding it domestically is the regime for Internet domain names (Bach 2010). Nevertheless, there are several reasons why the EU is particularly important to the embedding of international soft law in finance. The single market project, along with financial market integration and the EU response to the financial and sovereign debt crisis, has produced nearly two decades of constant legislating in the financial domain (Posner 2009b; Quaglia 2010). Moreover, the 'better regulation' project instituted a series of ongoing regulatory reviews and directive reforms, which further guarantee the routine reconsideration of regional rules of finance (Sabel and Zeitlin 2010).

Given this massive and institutionalized re-regulation process, the EU creates a significant opportunity structure for the embedding of global soft law standards within a multilevel governance process (Borzel and Risse 2000; Joachim 2003). This occurs in two principle ways. On the one hand, soft law can enter directly into EU law from the top down. We call this 'supranational imposition'. Increasingly. EU directives make direct reference to international soft law standards. For example, the Banking Directive and Capital Adequacy Directive of 2006 incorporate Basel II specifications.[2] As a result, all member states embedded this soft law reform promulgated by the non-treaty-based Basel Committee into their domestic law, just as it became legally binding at the supranational level. On the other hand, even in cases when the EU does not directly mandate the incorporation of specific soft law standards, the re-regulation process of Europe's financial markets repeatedly opens up the national legislative processes to transnational soft law entrepreneurs. EU directives 'unfreeze' the domestic regulatory agenda across a large number of countries by requiring implementing legislation (Borzel and Risse 2000; Posner 2009b; Weir and Skocpol 1985). As national parliaments consider such implementing legislation, lobby groups can press for the embedding of soft law rules and do so simultaneously, and with similar arguments, across almost 30 jurisdictions (Featherstone and Radaelli 2003). European integration creates an opportunity structure for transnational policy entrepreneurs to promote legislative change within member states. We call this second pathway 'national embedding'.

We expect that the pathway through which embedding happens to affect the diffusion of rules globally. Regardless of pathway, European domestic legal incorporation boosts the predictability of a soft law regime, which should spur adoption. Beyond that, however, differences emerge. First, in instances of supranational imposition, we expect EU officials to promote the adoption of the soft law standard far more actively than in cases of domestic embedding. The reason is that EU officials, in the former case, have a more direct stake in the soft law standard, want to avoid global fragmentation, and can leverage extraterritorial provisions of EU law. In national embedding, any active promotion largely bypasses EU officials and extraterritorial provisions, such as restricting market access to non-compliant foreign firms, occurs at the member state level only. Instead, national embedding provides legitimacy to transnational entrepreneurs as they attempt to promote their standard globally. Rapid adoption across member states allows entrepreneurs to invoke peer pressure, providing potential adopters with both a proof of concept and evidence that the standard will avoid fragmentation. Second, we expect that collective action problems would reduce a group of member states' ability to shape transnational standard evolution in national embedding, at least when compared to supranational imposition. Finally, whereas supranational imposition legitimizes and empowers a single soft law focal point for a domestic market of more than 500 million people, national embedding entails the possibility of slightly varying domestic adoption schemes, thereby leading to more of a 'focal zone' than a specific focal point. In sum, we expect accelerated global diffusion as a result of EU hardening regardless of pathway, but for diffusion patterns to vary by pathway.

In the following section, we examine two cases of international soft law in finance: accounting and close-out netting standards. Prior research on international accounting standards has produced two competing views, with one set of authors claiming the rise of the International Accounting Standards Board (IASB) is an instance of private actor global governance and others finding evidence for the club standards perspective by highlighting US and EU efforts to exert influence over IASB. Our goal is not to adjudicate between these competing views. Rather, it is to highlight the broader role of the EU in transforming global accounting standards from a voluntary regime based exclusively on soft law to an embedded and institutionalized set of rules backed by domestic and EU law. Our second case examines close-out netting standards for over-the-counter derivatives. Here, we explore the second pathway – national embedding.

DIFFUSION OF INTERNATIONAL ACCOUNTING STANDARDS THROUGH SUPRANATIONAL IMPOSITION

The international regulation of accounting standards often strikes outsiders as highly technical and arcane. Behind the complexities, however, sit the basic operating system of the global economy (Büthe and Mattli 2011; Veron 2007). Indeed, the stakes could not be higher – weak standards facilitate fraud and risk systemic stability as scandals such as the collapse of Enron or the securitization of debt in the 2008 financial crisis demonstrate (Eaton 2005).

Over time, diverse national accounting systems and standards have emerged across jurisdictions, each firmly rooted in its respective political economy. Not surprisingly, national rules tend to favor specific economic constituencies and support distinct styles of capitalism, privileging patient capital or shareholder interests (Botzem and Quack 2009; Nölke and Perry 2008). It is equally evident that divergent accounting standards across major markets generate inefficiencies and costs. By obstructing price discovery and hindering cross-border investments, they promote an inefficient allocation of capital and increase financing costs. Functional demand for harmonization is therefore logical. However, any such efforts carry substantial political risks because of the distributional implications identified above.

The path to global accounting harmonization has been shaped by these factors and has been anything but a straight line (Botzem 2012). From the 1970s to the early 2000s, little progress towards common global rules was made. In one forum after the next, competing interests stymied reform. Then, suddenly, in a matter of a decade, thousands of firms from Asia, Australia, Europe and the Americas began using International Financial Reporting Standards (IFRS) developed by the International Accounting Standards Board (IASB).[3]

Much of the existing literature focuses on the relative influence of different actors in shaping the content of IFRS. Power-based accounts such as Simmons (2001) or Posner (2010) explore the relative influence of the US and EU. Those emphasizing private actor governance stress the role of the epistemic community underpinning IASB (Perry and Nölke 2005; Porter 2005b). Finally, institutionalists such as Büthe and Mattli (2011) stress the institutional fit between domestic private sector organizations and the IASB.

Clearly, major powers as well as technical experts have shaped the content of IASB standards. A missing piece in existing accounts is the way in which EU involvement has transformed the character of the IFRS regime from a set of voluntary best practices to a highly institutionalized set of global rules. With the decision of the European Commission in 2002 to endorse IASB standards for European firms listed on qualifying exchanges, the EU embedded IFRS within the legal structure governing finance in Europe.[4] Ever since, EU regulators have actively monitored and enforced IFRS standards, and a close feedback loop has been established between them and IASB. While the EU has not taken over IASB, it has firmly woven IFRS rules into the fabric of European markets. This, in turn, has hardened IASB-promoted soft law, not just in Europe but around the world. The formal commitment to IFRS has increased the incentive for EU policy-makers to promote the IFRS regime globally. Through regional embedding, IFRS have received the regulatory backing of EU regulators endowed with considerable delegated authority, including the ability to enforce rules extraterritorially. EU hardening has prompted the EU to more directly engage the IFRS governance process. As a result, the level of uncertainty surrounding the IFRS project has fallen considerably.

Since the EU imposed IFRS supranationally, it was not necessary for individual member states to adopt implementing legislation. Instead, national and European regulators are directly responsible for overseeing the implementation of IFRS standards for firms across all member states. Moreover, the EU created an endorsement process through which a technical committee vets IASB standards for use in Europe. In contrast to many loose harmonization processes where transnational regulatory co-operation gradually inspires domestic reform, the EU–IFRS process features a formal and robust mechanism for embedding transnational private actors within the regional rule-making process.

Since the EU adoption of IFRS in 2002, there has been tremendous movement toward standards diffusion. A host of countries including Brazil, Korea, Mexico, Canada, Australia, Japan, Russia and China either require IFRS standards or have largely integrated IFRS standards into national rules.[5] In many of these countries, IFRS is used as the standard not only for listed companies but all domestic firms. Most striking perhaps, the Securities and Exchange Commission (SEC) has decided to allow foreign issuers to use IFRS without reconciling to US Generally Accepted Accounting Principle (GAAP) and is currently considering permitting domestic issuers to do so as well (Posner 2010).

EU adoption brought IFRS to the tipping point, setting off a tidal wave of adoption around the world and instigating a convergence unimaginable just a few years earlier. This is more than a story about an epistemic community of experts or market convergence on a focal point. Rather, the key moment, not just regionally but globally, was the hardening of soft law through its formal embedding in EU regulation. As the Financial Reporting Council of Australia explained its decision to embrace IFRS:

> [the timing] is determined by the decision of the European Union to require EU listed companies to prepare their consolidated accounts in accordance with IASB standards from that date, in support of the EU single market objective. Australia certainly cannot afford to lag Europe in this regard. (Australian Financial Reporting Council 2002: 1)

A critical feature of the 2002 regulation was the inclusion of an equivalency clause that required the European Commission to evaluate national accounting standards in third countries and determine their relative compliance with IFRS (Posner 2010). In cases where the Commission deemed the jurisdiction's standards equivalent, firms could list in European markets without reconciliation. In order to determine equivalence, the European Securities and Markets Authority (ESMA) conducts an evaluation of a jurisdiction's standards and makes a recommendation to the Commission.[6] The ESMA has conducted reviews of a number of critical markets, such as Canada, South Korea and India. In the case of Canada and South Korea, ESMA deemed the standards equivalent. In the case of India, however, the ESMA has held out its ruling, waiting to determine the full extent of reforms and putting additional pressure on the Indian government to converge. As David Boymal, the former chairman of the Australian Accounting Standards Board, explained the motivation for Australian reform:

> This change [in Australia] has got a very strong political aspect because it was done without reference to the constituents and it was done as a matter of

> urgency and under immense pressure from the Europeans. (Durkin and Fenton-Jones 2008: 69)

EU equivalence tests, then, create a legal mechanism through which EU regulators can lend coercive pressure to their efforts of promoting IFRS globally.

EU regulators have used other tools as well to promote IFRS, including capacity-building, trainings, and direct lobbying at the national level. The legitimacy and financial resources of European regulators thus back up and strengthen the informal institution of the IASB. In the words of the European Commission:

> The Commission is in contact with authorities responsible for accounting from countries all around the world in order to cooperate in the creation of a single reporting framework for companies listed on international markets.
>
> In that respect, the EU is promoting convergence of accounting standards of third countries with the (IFRS). On the way to full convergence the EU proposed to accept certain third country national accounting standards as equivalent with IFRS (as adopted by the EU) in order to facilitate cross-border listings.[7]

The engagement by the EU with other jurisdictions has shored up certainty in IFRS. As the Financial Reporting Council of Australia explains:

> The meetings [facilitated by the EU] added significantly to our understanding of global trends in accounting and auditing standards, and audit independence matters. It was clear that there was a genuine commitment to convergence around the globe. (Australian Accounting Standards Board 2006: 17)

European integration has produced an intricate set of implementation and enforcement tools, which serve to give IFRS teeth and promote a common enforcement of IFRS within the EU and beyond. Starting in 2003, the European Commission tasked ESMA to create an enforcement network comprised of national supervisory authorities. This network, known as European Enforcers Coordination Sessions (EECS), serves as a co-ordination mechanism for implementation at the regional level. Each year it agrees on enforcement priorities, compiles enforcement actions in a collective database for the members, and publishes key cases.[8] As such, EECS is refining the enforcement process within Europe, honing its tasks, and embedding IFRS within regional administrative law. While this reduces the flexibility commonly associated with soft law rules, this hardening dramatically increases the certainty associated with their diffusion.

As part of endorsing IFRS standards, the EU has actively engaged IFRS governance. Much of the scholarly literature on IFRS rule-making has focused on specific instances of influence; for example, whether the EU has been able to shift the content of IFRS rules concerning financial instrument reporting known as IAS 39 (Botzem 2012; Leblond 2011). While widespread use of carve-outs and transposition adjustments might threaten the predictability of the regime, EU continued participation in the regime signals its overall commitment to the project (Mügge 2011). In particular, the EU has called for greater oversight of IASB by public sector actors to assure accountability. In the wake of the financial crisis, this became a major focus of the G20. IASB has amended its constitution to create a Monitoring Board, comprised of public sector officials including the European Commission. This Monitoring Board meets regulatory with the IASB and must approve the trustees that serve as the ultimate decision-makers in the organization. Supranational imposition of IFRS by the EU has catalyzed an important feedback loop in which public authorities are directly involved in IASB governance (Richardson and Eberlein 2011; Veron 2007). EU engagement of the IFRS process not only has the potential to shape IFRS standards, but also increases the incentive for other countries to join the standards governance process. As the Australian Financial Reporting Council explains, 'European countries are working more closely together to provide early and considered input to the global standard setting process, and this highlights the need for Australia and other countries in the Asian region to do likewise' (Australian Financial Reporting Council 2005).

The accounting standards case demonstrates the important interaction of regional law and international soft law. In particular, it dispels a purely technocratic or power-based account. The embedding of transnational standards regionally is transforming the character of the global regime both by increasing the incentive for the EU to promote the standard and by increasing the predictability of the standard for potential adopters.

DIFFUSION OF DERIVATIVES REGULATION THROUGH NATIONAL EMBEDDING

The case of close-out netting regulation for over-the-counter (OTC) derivatives illustrates the way that EU embedding of soft law rules has global consequences for diffusion, even when there is no direct supranational imposition. Rather than mandating a specific solution supranationally, as in the accounting case, EU directives merely required member states in general terms to provide for effective close-out netting. Subsequent domestic implementation debates provided the International Swaps and Derivatives Association (ISDA), a private body comprising more than 800 financial institutions, law firms and other industry stakeholders, with an ideal opportunity to shape domestic law according to its preferred soft law solution. While ISDA has actively promoted such standards around the world, EU member states offered a particularly fertile ground for transnational lobbying. The implementation of financial directives, such as the 1996 Investment Services Directive and the 2002 Directive on Financial Collateral Arrangements, unfroze the specific areas of law targeted by ISDA in initially 15 and eventually over two dozen markets near-simultaneously. Rapid adoption in the EU, in turn, generated momentum for the diffusion of close-out netting rules globally. This bottom–up case highlights a more subtle way in which the EU can boost confidence in a given set of soft law rules and thus catalyze their uptake.

OTC derivatives are private contracts between two or more entities that are negotiated directly between the parties and are generally not mediated by regulated stock exchanges. Trading in OTC derivatives has surged over the past two decades. The Bank of International Settlement estimates that between 1998 and 2010 outstanding notional amounts rose from $60 trillion to more than $600 trillion. By comparison, global gross domestic product (GDP) in 2011 stood at only $70 trillion.

In light of these mind-boggling amounts, regulators have long been concerned about their implication for systemic stability (Mügge 2009). The original Basel capital adequacy standards issued in 1988 required banks to hold reserves against the notional value, or face value, of their derivatives exposure to protect against possible counterparty default or insolvency (Matthews 1995). While notional exposure increases with each individual contract, systemic risk is linked to net exposure. To illustrate this, imagine two banks, Alter and Ego. Alter has a contract obligating it to pay Ego $100. Separately, Ego has agreed to pay Alter $50. The notional exposure of both is $150. Yet, if Alter goes bankrupt, Ego should only lose $50, for even though Alter can no longer pay it the promised $100, Ego also no longer has to pay Alter the separately promised $50. Once the claims are offset, the net exposure is $50. In 1994, after industry advocacy and expert support, the Basel Committee modified its standards, allowing domestic regulators to let financial institutions hold reserve capital in proportion to their net derivatives exposure (*Ibid.*).

To facilitate derivatives trading and reduce associated transactions costs, leading global financial institutions in 1985 founded ISDA. The stated mission of the association, which in 2013 had members from more than 60 countries, is 'to make over-the-counter (OTC) derivatives markets safe and efficient'.[9] To this end, ISDA created and maintains the ISDA Master Agreement, a lengthy derivatives contract that trading parties employ to avoid costly *ad hoc* contract drafting. Employing the Master Agreement makes all transactions between two parties legally part of the same contract and enables close-out netting. ISDA estimates that close-out netting has reduced the credit exposure of financial institutions by 85 per cent (Mengle 2010). Put differently, if it were not for close-out netting provisions, banks alone would have needed $500 billion in extra capital in 2010 (*Ibid.*).

Close-out netting only works if it is compatible with applicable bankruptcy laws. The exposure reduction offered by close-out netting provisions only applies when positions can be netted prior to any other aspects of wind-down, liquidation or bankruptcy. Otherwise, in the example cited above, Ego might be obligated to pay Alter the promised $50 and then try to recover its $100, or at least a fraction, in a drawn-out bankruptcy proceeding. Prudent regulation would require Ego to prepare for the worst case, thus holding reserves against the full $150.

While close-out netting was feasible in some countries, even in leading markets such as the US bankruptcy law was originally incompatible with it. To address this problem, ISDA and its allies embarked on an ambitious global lobby campaign (Riles 2008; Tsingou 2003). In 1996, the association adopted a 'Model Netting Act' and lobbied governments to adopt it. The text modified a country's bankruptcy and insolvency laws to explicitly allow for close-out netting in the case of counterparty default.

ISDA's efforts with respect to Slovenia illustrate the association's approach. In a letter dated 30 October 2009, just as the country prepared to implement Directive 2009/44/EC on Settlement Finality and Financial Collateral Arrangements, ISDA explained to the minister of justice, the minister of finance, and the Bank of Slovenia the concept of close-out netting and argued its alleged benefits:

> As a result of these uncertainties … financial institutions and institutional investors inside and outside Slovenia that deal with Slovenian counterparties in financial transactions are at a competitive disadvantage, because they cannot confidently net their derivatives exposures against their Slovenian counterparties or rely on the terms set forth in their contracts.[10]

The efforts paid off: within a year of ISDA's lobbying, Slovenia amended its bankruptcy and financial markets laws to provide legal certainty for close-out netting. This enabled ISDA to commission an affirmative expert legal opinion that its members have since relied on to justify holding reserves for trades with Slovenian counterparties against net exposure only.

Slovenia is merely a case in turn. All in all, at least 38 countries had modified their bankruptcy codes in line with ISDA proposals by 2011 (Biggins and Scott 2012; Morgen 2008). According to the association, 'The longstanding consensus among industry and policy makers suggests that close-out netting is one of the more successful examples of international legal and regulatory harmonization' (Mengle 2010: 2).

While ISDA and the transnational soft law network it represents deserve credit for advancing netting legislation, the EU played a pivotal role in the diffusion process. The EU's first foray into this area was in 1996, when it asked member states to allow their banking supervisors, 'when assessing the compulsory capital cover for credit risks from OTC derivatives, to take into account the risk reducing effect of types of bi-lateral netting agreements' (European Commission 1996). The Directive did not force member states to modify their bankruptcy laws to allow close-out netting. It merely created the legal basis for member states' banking supervisor to allow lower reserves *if* the country already allowed close-out netting. It thus generated demand for netting-enabled bankruptcy laws without addressing supply, thereby creating an opportunity structure for ISDA's private sector policy entrepreneurs. In an interview, a senior ISDA representative underscored the critical role EU directives play in providing the organization with a window to achieve legislative change across numerous member states.[11] At the time of the 1996 EU Directive, close-out netting was only possible in the United Kingdom (UK), the Netherlands, Ireland and Germany. In the three years following the Directive, a total of nine additional EU countries incorporated ISDA-promoted provisions modifying their bankruptcy laws.

Figure 1 compares graphically the rate of adoption of close-out netting rules for EU countries and non-EU countries. Spikes in EU member state adoption following the passage of each of the two critical directives in 1996 and 2002 are clearly noticeable. In contrast, non-EU countries do not show a similar spike in the second half of the 1990s and the spike in the following decade trails developments in the EU by several years. Moreover, the share of EU members among adopters, especially in the earlier period, is striking. In 1999, 11 of 17 countries permitting close-out netting were EU members. The EU share reached its peak in 2004, when 17 out of 25, or 68 per cent, of all adopters were EU members. Subsequently the share fell as adoption outside the EU accelerated, and by 2011 EU members constituted just 55 per cent of all jurisdictions that had adopted close-out netting provisions.

The observed diffusion pattern of close-out netting rules is broadly consistent with our expectations. While the EU did not supranationally impose a specific soft law standard, its 1996 and 2002 directives created demand at the member state level and opened up the domestic legislative process, an opportunity for targeted lobbying that ISDA seized. Both directives were followed by a sudden uptick in close-out netting adoption within the EU, in contrast to the more gradual trend elsewhere. Clearly the Basle Committee's original embrace of netting and ISDA's lobbying played key roles. But it was the EU's endorsement of the concept, combined with the opportunities directive implementation afforded ISDA across a whole set of member states, that built momentum for close-out netting. With critical mass, competitive dynamics kicked in. The more jurisdictions embrace close-out netting for domestic transactions, the greater the competitive disadvantage for those who do not.

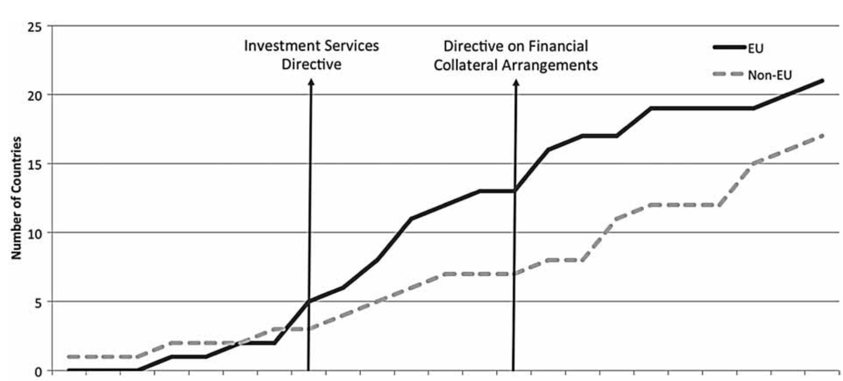

Figure 1 Modification of legislation to enable close-out netting, 1989–2011
Source: Authors' calculation using data from ISDA archive.

Moreover, the presence or absence of close-out netting provisions shapes capital flows. Given that leading US and British financial institutions can hold far less capital when trading derivatives with firms based in a jurisdiction were close-out netting is enabled than one where it is not, the former has a competitive advantage over the latter when it comes to attracting funds, regardless of the amount of domestic trading (Singer 2007).

The spread of close-out netting in the EU changed the calculus for other jurisdictions and provided important legitimacy for ISDA lobbying efforts. Critically, ISDA could leverage growing adoption across the EU as proof of concept, something it did directly and indirectly by enclosing an appendix of compliant jurisdictions with its outreach efforts.[12] While EU initiatives catalyzed adoption across member states, ISDA counted them as individual jurisdictions, thus creating a sense of important momentum. Within a year of the 1996 directive, when a review of Australian law suggested close-out netting might run into obstacles there, the head of the country's financial markets authority was alarmed: 'We are out of synch with the rest of the world. We need clarity, and the only way we can get clarity is to change the law' (Rogers 1997: 32). It is important to note that roughly two-thirds of this alleged 'rest of the world' were EU member states. Australia promptly modified its bankruptcy code to allow for close-out netting.

Similarly, the second wave of EU adoption triggered by the 2002 directive had repercussions elsewhere. In fact, the data show a slight lag after which diffusion among non-EU countries follows the pattern previously observed within the EU. Anecdotal empirical evidence suggests that advocates of pro-derivatives reform in many jurisdictions invoked 'international best practice', the role of ISDA and the EU, as well as the adverse competitive effects of remaining on the sidelines. Making the case for reform in the British Virgin Islands in 2007, financial lawyers Peter Tarn and Russell Willings argued:

> The combination of the EU's [2002] Financial Collateral Arrangements Directive and the adoption of netting legislation based on the ISDA Model Netting Act means that established practice in the derivatives market has been validated under corporate insolvency law in an increasing number of jurisdictions. (Tarn 2007: 32)

Importantly, even in 2013 rules across the EU were far from uniform. The 2002 directive went further than the original 1996 rules and explicitly asked member states to enable close-out netting.[13] Nevertheless, bankruptcy laws continue to vary across the EU and not all jurisdictions meet the threshold where close-out netting for all types of OTC derivatives is guaranteed. For these reasons, ISDA has lobbied the EU since 2008 for the adoption of a comprehensive netting directive to harmonize rules at the high end of netting provisions.[14] But even without supranational imposition, EU policy-making has been a potent catalyst of soft law hardening in Europe and global diffusion beyond.

In sharp contrast to the accounting case, however, the EU is far less engaged with ISDA than it is with IASB. EU officials neither actively endorse ISDA's private standards and benchmarks, nor have they sought to deliberately promote them through extraterritorial provisions or equivalency clauses. After EU member states supplied much of the critical mass, close-out netting rules have diffused through a combination of competitive pressure and ISDA lobbying. The diffusion process differs markedly from the case of accounting, where supranational imposition has given EU officials a much bigger transnational role. Nonetheless, the EU and the process of European financial integration were crucial for the spread of close-out netting regulation by catalyzing the hardening of ISDA standards through national embedding. This reduced the uncertainty surrounding the soft law rules, changed the calculus of follower jurisdictions, and boosted the legitimacy of ISDA claims as it lobbied non-European jurisdictions.

CONCLUSION

Ample research has shown that soft law is a staple of global finance and that the content of soft law rules and standards has distributional implications (Brummer 2011; Büthe and Mattli 2011; Oatley and Nabors 1998; Porter 2005a; Singer 2007). Earlier work has therefore focused on explaining the origins of various soft law networks (Kapstein 1992; Raustiala 2002; Zaring 1998), or has honed in on the influence and preference patterns shaping the content of rules and standards (Posner 2009a; Simmons 2001; Underhill and Zhang 2008; Mügge 2011). Our contribution broadens the debate by tracking how transnationally promulgated private standards interact with domestic law. We theorize that EU integration plays a key role in hardening soft law standards and find empirical support for two distinct causal pathways: supranational imposition and national embedding. We hypothesize that EU hardening shapes subsequent diffusion dynamics of soft law standards, and preliminary evidence is consistent with our expectations. EU hardening changes the calculus of follower jurisdictions, which in turn promotes adoption. This is especially the case for soft law incorporated in the EU via supranational imposition, because it gives EU officials a direct stake in the global soft law standards and enables the use of EU-level extraterritorial levers, such as the equivalency clause in accounting, in support of hastening global diffusion. But even in cases of national embedding, we find evidence that early and rapid adoption of a soft law standard in a large number of EU member states promotes adoption elsewhere. Our research, therefore, suggests that future studies of soft law diffusion, particular in global finance, should take EU membership, and the effects of domestic and regional law, into account.

More generally, our findings add an important caveat to skepticism regarding the role of soft law in global finance. Some critics have dismissed soft law networks because of their 'thin' level of institutionalization. The dynamics we have uncovered suggest that domestic rule-making forms part of the broader institutional fabric surrounding global soft law, and that domestic structures can give soft law a much 'thicker' degree of institutionalization than initially meets the eye (Helleiner and Pagliari 2011; Shaffer and Pollack 2009). The contribution adds to a growing literature that explores how private international law increasingly mixes with domestic regulation (Kaczmarek and Newman 2011; Lavelle 2011; Putnam 2009).

The evidence we have presented goes beyond standard rationalist accounts' focus on market and reputational incentives as the principal drivers of soft law adoption (e.g., Simmons 2001) and calls into question skeptics' view of soft law as epiphenomenal to great power interests and toothless owing to the underlying institutions lacking monitoring and enforcement capabilities (Abbott and Snidal 2000; Drezner 2007; Kahler and Lake 2009). However, not all of this is good news for soft law proponents. The speed and flexibility of such soft law standards has been held up in the literature as this form of governance's principal strength (Raustiala 2002; Slaughter 2004; Vabulas and Snidal 2013). Yet some of this speed and flexibility is lost as soft law becomes hardened. In fact, domestic hardening has a similar effect on private international law as does domestic treaty ratification in the case of public international law. Henceforth, transnational standard-setters cannot advance too far ahead of lead adopters such as the EU and may have to give public officials from lead adopters a formal voice in the process.

The Janus-faced nature of hardening for proponents of soft law – increasing its predictability, which spurs adoption while reducing its flexibility – raises the stakes for those interested in the normative implications of the standards involved. Rules like IFRS and close-out netting provisions have significant market consequences with potent distributional implications. Whether supranational imposition in Europe, and its effects on global diffusion of IFRS or netting rules, is a good thing depends on a given stakeholder's vantage point and the comparison to the respective *status quo ante*. Arguably, the harmonization of accounting standards has reduced transactions costs for cross-listing, boosted liquidity and thereby reduced the cost of financing. But not everybody will agree this is a good thing or that IFRS was the only way to achieve this. With close-out netting rules, the picture is even murkier. Such rules are clearly beneficial if the goal is to promote derivatives trading. However, in light of the role complex derivatives played in the financial crisis that began with the meltdown in US subprime mortgage-backed securities markets, critics might well argue that promoting derivatives trading is the last thing governments should do. While we do not take a position on these legitimate questions, we would argue that understanding how EU financial integration promotes the global spread of soft law, and how hardening makes these standards more sticky, is of interest to both proponents and opponents of a given soft law standard in global finance.

The most obvious area for future research raised by our study concerns how EU hardening interacts with other components of diffusion processes (Simmons and Elkins 2004). Transposition can vary and there is a growing literature attempting to explore the determinants of such variation (Botzem 2012; Eberlein and Richardson 2012; Sharman 2011). Future work should not only scrutinize how competition and mimesis affect adoption within the EU in cases of national embedding, but also how these factors come together in influencing non-EU jurisdictions. Moreover, future research should explore how the two distinct causal pathways for hardening might shape diffusion patters after adoption such as interdependent implementation and enforcement (Bach and Newman 2010).

Equally important is to explore how well the notion of soft law hardening travels beyond Europe and our two cases. We have argued that the ongoing process of EU financial market re-regulation provides ample opportunities for supranational imposition and national embedding, making the EU a prime hardening agent. While the motivation for transnational standards adoption is outside the scope of this contribution, this last point presents an important boundary condition for the argument. We would expect hardening to be more likely during periods of extensive market-making and re-regulation. Moreover, the case studies highlight the importance of internal policy paralysis as a precondition for the adoption of transnational rules. It was, for example, the clash of systems driven by different models of national accounting standards within the member states that made IFRS an attractive alternative to the Commission as opposed to home grown solutions. None of this means, however, that hardening is an exclusive EU domain. Complimentary studies examining the interaction of transnational soft law and domestic regulation in the US seem consistent with our findings (Lavelle 2011). Similarly, the pattern that we identify in accounting and derivatives appears in other sectors, such as banking and auditing, where the EU has embedded transnational soft law into regional legislation.[15]

Our study suggests that soft law in global finance may not be so soft after all. The EU in particular plays a crucial role in hardening soft law through regional embedding, which in turn promotes the formal adoption of soft law standards in other jurisdictions. While EU hardening significantly reduces the risk of standards fragmentation, it also, paradoxically, makes the standard less flexible and amendable to change. Our findings are not the last word on this topic and we have identified several open questions as areas for future research. What they suggest even at this point, however, is that the pieces comprising the tapestry of global governance – transnational private governance, European integration and domestic law – in finance are increasingly intertwined.

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ACKNOWLEDGMENTS

We would like to thank the editors, as well as two anonymous reviewers, who made invaluable suggestions. In addition, we thank participants at the conference on Europe and Global Finance organized by Daniel Mügge at the University of Amsterdam, 14–15 February 2013. In addition, we received very useful feedback from Burkard Eberlein, Calvin Huntington, Rahul Kaul, Stefano Pagliari, Tony Porter, Elliot Posner, Lucia Quaglia, Eleni Tsingou, Kevin Young, David Zaring and Jonathan Zeitlin.

NOTES

1 In terms of institutionalization, we follow Ruggie (1998: 2) who focuses on predictability of behavior structured in large part by organizational routines. He identifies international organizations with their bureaucratic capacities as the key mechanism for institutionalization internationally. Given the non-treaty-based nature of soft law, many observers have described them as thinly institutionalized or network-based. See, for example, Zaring (2004).

2 'The provisions in . . . Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (4), form an equivalent to the provisions of the Basel framework agreement.' Directive 2006/48/EC of the European Parliament and the Council of 14th June 2006 relating to the taking up and pursuit of the business of credit institutions. *Official Journal of the European Union*, 30 July 2006: L 177.

3 We refer to the organization as the IASB. Prior to 1999, the organization was named the International Accounting Standards Committee (IASC).

4 Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards. *Official Journal of the European Communities*, 11 September 2002: L 243.

5 http://www.iasplus.com/en/resources/ifrs-topics/use-of-ifrs (accessed 12 February 2014).

6 Prior to the financial crisis, ESMA was known as the Committee of European Securities Regulators (CESR).

7 http://ec.europa.eu/internal_market/accounting/third_countries/index_en.htm

8 See http://www.esma.europa.eu/page/IFRS-Enforcement-0 (accessed 12 February 2014).

9 'About ISDA', available at http://www2.isda.org/about-isda/ (accessed 26 January 2013)

10 Letter dated 30 October 2009 by Peter M. Werner of ISDA to Aleš Zalar, Minister of Justice of Slovenia, available at http://www.isda.org/speeches/pdf/SVN_NettingLtr-MoJ_v1.pdf (accessed 9 February 2013).

11 Interview with ISDA official.

12 See ISDA comment letters to jurisdictions at http://www.isda.org/speeches/comments.html (accessed 9 February 2013).

13 See Article 7 of Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.

14 'ISDA proposes harmonization of netting in Europe', Press Release, 17 April 2008.

15 The 2006 EU Capital Adequacy Directive and the 2006 Auditing Directive both rely on international standards. The Auditing Directive is still awaiting implementation.

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