

2008

The Subprime Mortgage Crisis: Will it Change Foreign Investment in US Markets?

Lindsay Joyner

Follow this and additional works at: <https://scholarcommons.sc.edu/scjilb>



Part of the [Banking and Finance Law Commons](#), [International Law Commons](#), and the [Transnational Law Commons](#)

Recommended Citation

Joyner, Lindsay (2008) "The Subprime Mortgage Crisis: Will it Change Foreign Investment in US Markets?," *South Carolina Journal of International Law and Business*: Vol. 4 : Iss. 2 , Article 5.
Available at: <https://scholarcommons.sc.edu/scjilb/vol4/iss2/5>

This Article is brought to you by the Law Reviews and Journals at Scholar Commons. It has been accepted for inclusion in South Carolina Journal of International Law and Business by an authorized editor of Scholar Commons. For more information, please contact digres@mailbox.sc.edu.

THE SUBPRIME MORTGAGE CRISIS: WILL IT CHANGE FOREIGN INVESTMENT IN US MARKETS?

Lindsay Joyner

In August 2007, as the first effects of what has become a mortgage market crisis were being felt throughout the United States, a *New York Times* article, "Calls Grow for Foreigners to Have a Say on US Market Rules," reported that foreign investors were beginning to feel that in regard to the US export of financial products, "losses to investors in other countries suggest[ed] that American regulators [were] not properly monitoring the products or alerting investors to the risks."¹ As American markets constantly change and evolve through the creation of original financial products, the demand from foreigners for American financial products has rapidly grown. Thus, foreign investment has become increasingly vital to maintaining and increasing the US Gross Domestic Product (GDP), the "market value of goods and services produced by labor and property in the United States, regardless of nationality."²

To an outsider looking onto the financial markets of the US, it seems that the goal of the US government and all organizations in charge of regulating the securities markets should be to keep and encourage foreign investors rather than to drive them into investing in the growing Asian or European markets. Yet with the recent losses from the subprime mortgage market starting to expand into other types of investment markets, including the bond market through Collateralized Debt Obligations (CDOs),³ it does not seem as if US markets are inspiring confidence in foreign investors. CDOs, most often owned by investment banks, hedge funds, insurance companies, and public pension plans, are bonds backed by subprime home loans, yet losses on subprime mortgages have caused interest payments to stop.⁴

¹ Heather Timmons and Katrin Bennhold, *Calls Grow for Foreigners to Have a Say on US Market Rules*, N.Y. TIMES, Aug. 29, 2007, available at <http://www.nytimes.com/2007/08/29/business/worldbusiness/29regulate.html>.

² Bureau of Economic Analysis, Glossary, http://www.bea.gov/bea/glossary/glossary_g.htm (last visited January 12, 2008).

³ Vikas Bajaj, *Mortgage Security Bondholders Facing a Cutoff of Interest Payments*, N.Y. TIMES, Oct. 22, 2007, available at <http://www.nytimes.com/2007/10/22/business/22market.html>.

⁴ *Id.*

Under conditions such as these, should the US find a way for international investors to monitor the risks of their investments other than American rating systems? Additionally, how could the US create the rights to monitor in foreign investors using the current tools of international law? Lastly, if a foreign State were to generate a law governing US markets, would that State be able to enforce its law in the US?

To address questions such as these, this paper looks at the current state of investment including in it a discussion of the current credit rating systems, the international market for US securities, and the recent subprime mortgage market problem. After laying the foundation of the current system, the note discusses the possibility of creating rights and how those rights could be created in foreign investors to have a greater role in or a better understanding of rating securities.

Additionally, this paper looks to enforcement issues that may arise should a foreign State try to create regulations concerning US markets. Finally, the note weighs the costs and benefits of a universal rating system for securities including those listed on the US financial markets. As the many technological advances of the end of the 20th century and the beginning of the 21st century have caused and/or increased globalization, an international system for rating securities may be the most helpful and plausible answer to maintaining foreign investment in the US.

I. BACKGROUND ON THE CURRENT STATE OF INVESTMENT

A. *Current Security Rating Systems*

With the recent losses experienced by foreign investors, faith in the ratings of securities has rapidly declined. Investors seem to be blaming their decisions on how the securities were rated and the securities' inability to perform in a manner that would merit their rating. Although "globalization of financial markets" has led to an increasing number of credit rating agencies throughout the world, "the reliance on credit ratings was confined" to the US for most of the 20th century.⁵ Credit Agencies have as their objective "provid[ing] [their] opinion on the creditworthiness of an entity and the financial obligations (such as, bonds, preferred stock, and commercial paper) issued by an entity."⁶ Thus, after research into the security being offered, the

⁵ SEC, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS, AS REQUIRED BY SECTION 702(B) OF THE SARBANES-OXLEY ACT OF 2002 5 (2003), available at <http://www.sec.gov/news/studies/credratingreport0103.pdf>.

⁶ SEC Fast Answers, Credit Rating Agencies-NRSROs, <http://www.sec.gov/answers/nrsro.htm> (last visited Feb. 3, 2008).

credit agency must decide whether it is “investment grade,” and upon that decision, the rating given to the security expresses the level of risk to the investor.⁷

Although different rating agencies have different rating systems, generally, in order to denote how risky a security is, each security is given a letter rating.⁸ According to Standard & Poor’s Rating Services (S&P), credit ratings are based on the likelihood of payment, the nature and provision of obligations, and “[p]rotection afforded by, and relative position of, the obligation in the event of bankruptcy, reorganization, or other arrangement under the laws of bankruptcy and other laws affecting creditors’ rights.”⁹ After taking the above elements into account, securities are given a series of letters corresponding to their level of risk. For example, under the S&P rating system, an “AAA” rating is the highest, meaning that the “obligor’s capacity to meet its financial commitment on the obligation is extremely strong.”¹⁰ In order of increasingly speculative characteristics (more risk), “AA,” “A,” “BBB,” “BB,” “B,” “CCC,” “CC,” “C,” and “D” ratings may also be given.¹¹ However, a rating of “D” infers that the security is in payment default and is only used when payments have not been made “on the due date even if the applicable grace period has not expired;” additionally, “D” is used “upon the filing of a bankruptcy petition or the taking of a similar action if payments on an obligation are jeopardized.”¹²

Credit Rating Agencies have been around since the beginning of the 20th century. Well-known agencies like Fitch, Inc. (Fitch), Moody’s Investment Service (Moody’s), and Standard & Poor’s Rating Services (S&P) have been doing business since 1913, 1909, and 1906, respectively.¹³

⁷ *Id.*

⁸ *Id.*

⁹ Standard & Poor’s Rating Services, Definitions: Long-Term Issue Credit Ratings, <http://www2.standardandpoors.com/portal/site/sp/en/us/page.article/2,1,1,4,1204834067208.html> (last visited Feb. 3, 2008).

¹⁰ *Id.*

¹¹ *Id.*

¹² *Id.*

¹³ Fitch Ratings, Inc., About Fitch Ratings, History of Fitch Ratings, <http://www.fitchratings.com> (last visited Feb. 3, 2008) (stating Fitch Ratings was “founded as the Fitch Publishing Company on Dec. 24, 1913” and published financial statistics for consumers including the New York Stock Exchange); Moodys.com, Moody’s History, <http://www.moodys.com/moodys/cust/AboutMoodys/AboutMoodys.aspx?topic=history> (last visited Feb. 3, 2008) (stating Moody’s went out of business during the stock market crash of 1907 but came back in 1909 with the idea to “publish a book that

Additionally, the aforementioned agencies are Nationally Recognized Statistical Rating Organizations (NRSROs), which are those credit agencies that have registered with the Securities and Exchange Commission (SEC).¹⁴ In 1975, Fitch, Moody's, and S&P were the first ratings firms to be considered NRSROs by the SEC because they were nationally used.¹⁵ Currently, there are seven NRSROs including: A.M. Best Company, Inc.; DBRS Ltd.; Fitch; Japan Credit Rating Agency, Ltd.; Moody's; Rating and Investment Information, Inc.; and S&P.¹⁶ NRSROs' ratings "today are widely used as benchmarks in federal and state legislation, rules issued by financial and other regulators, foreign regulatory schemes, and private financial contracts."¹⁷

The process of becoming a NRSRO has recently changed from designation to registration because of the passage of the Credit Rating Agency Reform Act of 2006.¹⁸ Under this Act, credit rating agencies must "disclose their procedures and methodologies for assigning ratings [and] . . . make public certain performance measurement statistics including historical downgrades and default rates."¹⁹ Like the effect of registration requirements for securities that are to be listed on a stock exchange, the oversight created by the Act was to give investors a feeling of greater protection through increased "accountability, transparency, and competition in the credit rating industry."²⁰

Registration of NRSROs came about after the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), Section 702, required the SEC to prepare a report on the "role and function of credit rating agencies in the operation of securities markets."²¹ Sarbanes-Oxley required this report by the SEC in order to achieve one of its primary purposes: "to assure the integrity of the United States capital markets and restore investor confidence in the wake of financial scandals."²² Although alternatives to NRSROs had been discussed before the financial

analyzed the railroads and their outstanding securities," and from there, Moody's began expanding its base of analyzed companies); Standard & Poor's, About S&P, Company History, <http://www2.standardandpoors.com/portal/site/sp/en/us/page> (last visited Feb. 3, 2008) (stating that in 1906 the Standard Statistics Bureau was formed to provide financial information on US companies that had been unavailable).

¹⁴ SEC Fast Answers, *supra* note 6.

¹⁵ SEC, *supra* note 5, at 8-9.

¹⁶ SEC Fast Answers, *supra* note 6.

¹⁷ SEC, *supra* note 5, at 5.

¹⁸ Press Release, Sec. and Exch. Comm'n, Seven Credit Rating Agencies Register with SEC as Nationally Recognized Statistical Rating Organizations (Sept. 24, 2007), available at <http://www.sec.gov/news/press/2007/2007-199.htm>.

¹⁹ *Id.*

²⁰ *Id.*

²¹ SEC, *supra* note 5, at 3.

²² *Id.*

scandals and the institution of Sarbanes-Oxley, nothing was done to achieve greater oversight of the credit rating agencies until after the subprime mortgage market had already started to fall apart.²³

Even though most of the credit rating agencies mentioned above have existed for bordering on a century and have an increasingly international reach,²⁴ recent events, most notably the subprime mortgage market collapse, have still caused a decline in faith in these systems. Criticism of the agencies stems from actions by the credit rating agencies in the ratings given to these securities. According to, "Credit ratings fueled subprime boom," an article in the *Seattle Post-Intelligencer*, "[a]bout 80% of the [subprime mortgage] securities carried AAA ratings, the same designation given to US Treasury bonds," yet the subprime mortgage securities offered "higher returns than the government bonds with the same ratings."²⁵ Thus, investors began purchasing subprime securities over US Treasury bonds because they were rated so as to infer they were safe while offering greater return potential. However, in the aftermath of the failure of the subprime mortgage market, the trust in credit rating agencies has transformed into a "feeling of betrayal."²⁶

B. Current Foreign Investment in US Markets

Unlike the isolationist nation created in the halls of Philadelphia in 1787, dividing the fledgling nation from the rest of the world with the newly created Constitution, the United States no longer tries to maintain trade only within its borders. Globalization has become commonplace as "[f]iber optics

²³See *id.* at 10 (discussing the three alternatives to NRSROs: "(a) eliminating reliance on NRSRO for purposes of Commission rules, (b) retaining the use of NRSRO ratings in Commission rules and the current method for designating rating agencies as NRSROs, and (c) implementing more direct and expanded oversight of credit rating agencies").

²⁴Fitch, *supra* note 13 (stating it has 49 worldwide offices today); Moodys.com, About Moody's, http://www.moodys.com/moodys/cust/AboutMoodys/AboutMoodys.aspx?topic=intro&redir_url=/cust/AboutMoodys/staticRedirect.asp (last visited Feb. 2, 2008) (tracking debt in more than "100 sovereign nations"); Standard & Poor's, About S&P, Overview, <http://www2.standardandpoors.com/portal/site/sp/en/us/page> (last visited Feb. 3, 2008) (reporting credit ratings of outstanding debt at a sum of "\$34 Trillion in 100 countries").

²⁵Kathleen M. Howley, *Credit ratings fueled subprime boom*, SEATTLE POST-INTELLIGENCER, Dec. 27, 2007, available at http://seattlepi.nwsourc.com/business/344991_subprime27.html.

²⁶*Id.* (quoting Sylvain Raynes, "a former Moody's analyst who now is a principal at R&R Consulting").

and the satellite now allow money to move quickly throughout the world.”²⁷ Today, computers and even smart phones provide instant gratification to investors looking for current prices and other information on worldwide securities. Making the world flatter has reduced information asymmetry so that “raising capital and investing can happen anywhere and . . . everywhere.”²⁸

The US Census Bureau’s 2008 Statistical Abstract (Abstract) publishes the current estimates of foreign investment in the US.²⁹ The Abstract presented the international investment position by using a table that shows, among other things, foreign investment in the U.S from the year 2000-2006.³⁰ Factors considered in determining the numbers provided in the Abstract include “[t]he movement of foreign and US capital[,] . . . changes in prices of securities, defaults, expropriations, and write-offs.”³¹ According to the Abstract’s estimates for the end of the year, foreign-owned US securities other than US Treasury securities grew from \$2,623 billion in 2000 to \$5,229 billion in 2006.³² However, foreign investment coming into US markets was not the only interesting estimate offered. For the same time period, 2000-2006, US private assets in foreign securities grew from \$2,426 billion to \$5,432 billion, respectively.³³ Although the numbers are not identical, they are comparable. Thus, US investment in foreign securities differed from foreign investment in US securities mainly in that foreign investment seemed to steadily increase for the time period offered while US investment decreased in 2001 and 2002.³⁴ Yet the dip likely may have occurred because of the events of September 11, 2001 and their aftermath on the US economy and investing potential.

Although raw dollar amount data for foreign investment in US markets is an essential statistic in studying foreign investment, the percentage growth of that foreign investment in comparison to the total volume growth in US markets also merits mention. When comparing foreign investment growth to the volume of trading increase on an exchange market, such as the New York Stock Exchange (NYSE), foreign trading grew quicker than the

²⁷ JAMES D. COX, ROBERT W. HILLMAN, & DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES & MATERIALS 99 (5th ed. 2006).

²⁸ *Id.*

²⁹ See US CENSUS BUREAU, THE 2008 STATISTICAL ABSTRACT: 2008 EDITION 783 (2007), available at <http://www.census.gov/prod/2007pubs/08abstract/foreign.pdf>.

³⁰ *Id.*

³¹ *Id.*

³² *Id.* at 789, Table 1261 (citing US Bureau of Economic Analysis, *Survey of Current Business*, July 2007).

³³ *Id.*

³⁴ *Id.*

exchange from the years of 1984-1994 as it rose “at a compound rate of 18.5 percent, whereas annual volume on that exchange [grew] at 12.34 percent.”³⁵

Since the amount of foreign investment has become so large, the question on the minds of many regulators in the US is how to maintain security while maintaining the growth of US markets through foreign investment. To solve those worries, The Committee on Foreign Investment in the United States (CFIUS) has been charged with “overseeing the national security implications of foreign investment in the economy.”³⁶

Although CFIUS was created by an executive order of President Ford, the 109th Congress wanted to amend its role after concern grew over the purchase of six American ports by Dubai Ports World (DP World).³⁷ About a decade and a half before the renewed interest in CFIUS by the 109th Congress, President Ronald Reagan signed the Omnibus Trade and Competitiveness Act of 1988 which included Section 5021, better known as the Exon-Florio Provision.³⁸ At the time the Exon-Florio Provision was passed, Congress was worried that “foreign takeovers of US firms could not be stopped unless the President declared a national emergency or regulators invoked federal antitrust, environmental, or securities laws.”³⁹ However, Congress did not intend for the provision to change the generally open policy of foreign investment in US markets.⁴⁰ President Reagan later, through Executive Order 12661, broadened CFIUS’s authority by making it an advisory committee that advised the President directly.⁴¹ Additionally, President Reagan gave CFIUS the ability to make recommendations concerning foreign investment.⁴² Currently, the twelve members of this interagency committee consist of

Secretaries of [1] State, [2] the Treasury, [3] Defense, [4] Homeland Security, and [5] Commerce; [6] the United States Trade Representative, [7] the Chairman of the Council of Economic Advisers; [8] the Attorney General; [9] the Director of the Office of Management and Budget; [10] the Director of the Office of Science and Technology Policy; [11] the Assistant to the President for

³⁵ COX, *supra* note 27, at 100 (citing NYSE Fact Book 1994).

³⁶ JAMES K. JACKSON, THE COMMITTEE ON FOREIGN INVESTMENT IN THE UNITED STATES, CRS No. RL33388, at 1 (2007), *available at* <http://www.fas.org/sgp/crs/natsec/RL33388.pdf>.

³⁷ *Id.* at 1-2 (stating that the events of Sept. 11, 2001 changed the “nation’s economic and security concerns,” and these changes “require a reassessment of the role of foreign investment in the economy and in the nation’s security”).

³⁸ *Id.* at 5.

³⁹ *Id.*

⁴⁰ *Id.* at 6.

⁴¹ *Id.*

⁴² *Id.*

National Security Affairs; and [12] the Assistant to the President for Economic Policy.⁴³

Even with all of those high-powered people in attendance on the committee, in the wake of the DP World attempted acquisitions of ports and other transactions, Congress has increased its oversight of CFIUS and has expressed its discontent with the committee.⁴⁴ However, most economists do not believe in placing restrictions on the “inflow of foreign investment.”⁴⁵ Economists have conceded though that there are costs and benefits to foreign investment that should be taken into account.⁴⁶ The benefits include: added capital and potential for “productivity growth and innovation.”⁴⁷ Yet foreign investment also conveys “dollar-denominated assets to foreign investors,” who have a choice of how to reinvest that money, and “repatriated capital and profits” are removed from the US economy reducing the entire amount of capital in the US economy.⁴⁸ Thus, foreign investment represents both benefits and costs that have to be balanced before any regulation is passed.

Globalization has also initiated an “increasing interconnectedness of capital markets.”⁴⁹ An event demonstrating interconnectedness that is somewhat reminiscent of the current subprime mortgage market crisis transpired on October 19, 1987.⁵⁰ This event, known as “Black Monday,” occurred when the Dow Jones Industrial Average (the Dow) “plunged 508 points or 22.6 percent.”⁵¹ This event set into motion a domino effect on the Tokyo and London markets causing them to post one-day declines of 14.7 percent and 12.2 percent, respectively.⁵² Thus, although foreign investment in U.S securities is in the thousands of billions of dollars, the interdependence of the major world markets created by globalization may require more than just US securities regulations to maintain a healthy market.

C. The Subprime Mortgage Collapse

Subprime mortgage securities seemed like the proverbial light at the end of a tunnel or the return of the withered “American Dream” for America’s middle class, a group who was feeling that it had less purchasing power due to

⁴³ *Id.*

⁴⁴ *Id.* at 23.

⁴⁵ *Id.* at 24.

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ COX, *supra* note 27, at 101.

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.*

an increasing gap of wealth between America's most affluent and it. Unfortunately, the subprime mortgages' stint as savior was short-lived because, in effect, they were a band-aid trying to patch up a gaping wound.

Subprime lending, known most simply as high-cost lending, "emerged in the early 1980s" after the adoption of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA), Alternative Mortgage Parity Transaction Act of 1982 (AMPTA), and the Tax Reform Act of 1986 (TRA), yet subprime lending only grew rapidly after 1995.⁵³ From 1995-1998, the number of subprime fixed-rate mortgages (FRMs) and subprime adjustable-rate mortgages (ARMs) originated was increasing at a fairly quick rate; however, the subprime mortgage market took a slight downturn from 1998-2000 when "the total number of FRM originations declined."⁵⁴ Yet, after 2000, the subprime mortgage originations resumed their growth.⁵⁵ "LoanPerformance" reported a 62% increase in the number of their subprime mortgage originations for the year 2002-2003, and "Inside Mortgage Finance" posted a 56% increase in the same area.⁵⁶

Subprime mortgages differ from prime mortgages in one very important respect: "the upfront and continuing costs are higher for subprime loans."⁵⁷ Upfront costs arise when originating the loan, so they tend to include things like application and appraisal fees.⁵⁸ Although it would seem that upfront fees would be the same for both prime and subprime mortgages, it has been reported that they differed because factors such as the borrowers' credit history and "prepayment risk" have an effect on loan pricing.⁵⁹ Continuing costs, as the name implies, cover costs that go into keeping a mortgage alive; therefore, they consist of "[1] mortgage insurance payments, [2] principle and interest payments, [3] late fees and delinquent payments, and [4] payments from locality (such as property taxes and special assessments)."⁶⁰ Even though subprime mortgages had higher upfront and continuing costs, they "expand[ed] the pool of credit to borrowers who, for a variety of reasons,

⁵³ Souphala Chomsisengphet & Anthony Pennington-Cross, *The Evolution of the Subprime Mortgage Market*, 88(1) FEDERAL RESERVE BANK OF ST. LOUIS REVIEW January/February 2006, at 31, 41, available at <http://research.stlouisfed.org/publications/review/06/01/ChomPennCross.pdf> (discussing "basic information about subprime lending and how it has evolved, to aid the growing literature on the subprime market and related policy discussions").

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Id.* at 32.

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.*

would be denied credit.”⁶¹ As the subprime mortgage originations allowed more people to purchase houses, the increase in number of borrowers who could receive credit made subprime mortgages the champion of the return of the “American Dream.” Since one of the primary ways a household can build wealth is homeownership, it has become a key economic factor; therefore, increased homeownership and increased opportunity for households to build wealth were benefits of subprime lending.⁶² Yet those benefits were never realized because missed payments and foreclosures became the only consequences of subprime mortgages.

The beginning of the end for subprime mortgages occurred in 2006. After the peak of the housing market in 2005, the following year marked the beginnings of a slow down as new home sales were down 17.3% from 2005.⁶³ Additionally, 2006 saw a drop in existing home sales: 8.4%.⁶⁴ The housing market, or what has now been considered the housing bubble, started ballooning greatly when the Federal Reserve Board (the Fed) slashed short-term interest rates from 2000 to 2004.⁶⁵ However, as the housing market grew, the lending standards used became more cavalier as new mortgage products like “‘stated income’ loans, . . . ; ‘piggyback’ loans, . . . ; and ‘option ARMS’ were permitted to enter the market.”⁶⁶ When new standards were actually agreed upon, they covered some of the newest financial loan creations, but the Fed did not include subprime mortgages in those standards.⁶⁷ Standards for subprime mortgages were actually not created until July 29, 2007, and by that point, the damage had already been done as “30 subprime lenders had gone out of business and many more were headed that way.”⁶⁸

In the midst of the collapse of the subprime mortgage market, experts have pointed their fingers in several different directions as to how the market could have collapsed, almost completely, in such a short period of time. Many have questioned how or why US governmental agencies, or any regulatory body, did not get involved sooner.⁶⁹ As early as 2001, “Treasury

⁶¹ *Id.* at 31.

⁶² *Id.*

⁶³ Dean Baker, *2007 Housing Bubble Update: 10 Economic Indicators to Watch*, CENTER FOR ECONOMIC AND POLICY RESEARCH Feb. 2007 at 1-2, available at http://www.cepr.net/documents/publications/housing_indicators_2007_02.pdf.

⁶⁴ *Id.* at 4.

⁶⁵ Edmund L. Andrews, *Fed Shrugged as Subprime Crisis Spread*, N.Y. TIMES (Dec. 18, 2007) available at <http://www.nytimes.com/2007/12/18/business/18subprime.html?th&emc=th>.

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ *Id.*

official, Sheila C. Bair, tried to persuade subprime lenders to adopt a code of ‘best practices’ and to let outside monitors verify their compliance.”⁷⁰ But, her idea was not well-received by the lenders, and the status quo was maintained until it was too late.⁷¹ The Fed has been one of the main targets of blame as decisions by the Federal Reserve and other regulatory agencies have shown that they “waited until it was too late to try to tame the industry’s excesses.”⁷²

Additionally, the Fed repeatedly held that there was not a housing bubble even going so far as to say that declines felt in the real estate market would be local but “almost certainly not nationwide.”⁷³ Unfortunately, as it turned out, that position was incorrect.⁷⁴ However, the Fed was not the only agency that did not proceed with caution in the subprime mortgage market as “virtually every federal bank regulator was loathe to impose speed limits on a booming industry.”⁷⁵ Additionally, the limits were difficult to create and enforce because the regulators were “an alphabet soup of agencies with splintered and confusing jurisdictions;” consequently, not all mortgage lenders fell into any of the agencies’ jurisdictions.⁷⁶

Although traditionally mortgages were thought of as a loan between one lender and one borrower, the subprime mortgage market crisis has shown otherwise as the effects of its collapse on the US economy and potentially the global economy have yet to be determined; instead, the trend seems to be that they are growing each day. With subprime mortgages, the lenders were “financed by investors on Wall Street who b[ought] packages of loans called mortgage-backed securities”⁷⁷ Mortgage-backed securities have “significantly altered the role of institutions in residential real estate financing and expanded the availability of financing for real estate purchases.”⁷⁸ These securities allowed institutions like banks to avoid becoming the “long-term lender” for the real estate purchaser; instead, they could dispose of the risk by “develop[ing] a pool of mortgages, transfer[ing] th[ose] mortgages to a trust, and caus[ing] the trust to sell undivided interests in itself to large numbers of investors.”⁷⁹

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Id.*

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ COX, *supra* note 27, at 92.

⁷⁹ *Id.*

Some, or in reality probably many, of these investors were foreign and had never seen the houses being purchased let alone met the purchasers that they were helping by investing in securities backed by subprime mortgages. Thus, these investors “were pouring trillions of dollars into American securities. Much of that money, often described as the ‘global savings glut,’ flowed directly into mortgage-backed securities that were used to finance subprime mortgages.”⁸⁰

II. ANALYSIS

A. Creating Rights in Foreign Investors through Sources of Transnational Law

As there is currently no specific way for foreign investors to regulate or even to have greater say in the rating and regulation of securities in US markets, a right would have to be created through some source of transnational law if foreign investors are ever going to see their desires come to fruition. Transnational law contemplates “all law which regulates actions or events that transcend national frontiers. Both public [international law] and private international law are included, as are other rules which do not wholly fit into such standard categories.”⁸¹ Although some sources of transnational law are considered to be more significant than others, current sources include treaties, customary international law, general principles of law, teachings of scholars, regulatory regimes, non-binding “soft law,” and international private law. However, this paper is limited in that it will look only to the possibility and practicality of using treaties, customary international law, and regulatory regimes to create an international system for rating securities.

1. Treaties

Although there is no treaty directly discussing the regulation rights of foreign investors over US securities, it may be possible to use established treaties, including those that created important international organizations such as the United Nations (UN), the World Trade Organization (WTO), and Organization of Economic Cooperation and Development (OCED), as a guide to whether the rights that foreign investors are searching for can be created and sustained.

Originally, States were the only actors who could generate and enforce treaties. To this end, the Vienna Convention on the Law of Treaties (VCLT), as a “treaty on treaties,” was created to define and describe treaty law

⁸⁰ Andrews, *supra* note 65.

⁸¹ PHILIP JESSUP, TRANSNATIONAL LAW 2 (Yale Univ. Press 1956).

rules.⁸² In Article 2 of the VCLT, a “treaty” is defined under the Convention as “an international agreement concluded between States in written form and governed by international law.”⁸³ Therefore, if a treaty is between non-State actors, it is not governed by the VCLT; however, the existence of the VCLT does not mean that an agreement will not be binding as between non-State actors.⁸⁴ Instead, the VCLT offers guidelines that must be accomplished when States enter into treaties. Thus, if the US and the United Kingdom, or any other combination of the US and a foreign State, decided to create investor rights in regulating US securities’ ratings, that treaty would fall under the jurisdiction of the VCLT. Bilateral treaties such as that suggested above would not likely work in practicality because the origin of foreign investors are so varied.

However, if the US only wanted British investors to have special rights, those rights could be created through a bilateral treaty or a multilateral treaty depending on how many countries with whom the US wanted to contract.⁸⁵ To meet all of the requirements of the VCLT, a treaty would have to be “in written form and governed by international law” as well as adopted and ratified pursuant to “Part II” of the VCLT.⁸⁶ The extent of any treaty created between the US and any number of other States would be “controlled by the intent of the parties.”⁸⁷

A comparable treaty to what would have to be created to give the investors of a country the rights to regulate US securities is the Bilateral Investment Treaty (BIT) between the US and Argentina.⁸⁸ In the BIT between the US and Argentina, Article I provides that “investment” means “every kind of investment in the territory of one Party owned or controlled directly by nationals or companies of the other Party, . . . [including] tangible and intangible property, . . . , such as mortgages, liens and pledges.”⁸⁹ From that early definition of investment, the treaty goes on to cover investors’ rights in

⁸² DAVID J. BEDERMAN, *INTERNATIONAL LAW FRAMEWORKS* 27 (Foundation Press 2d ed. 2006) (2001).

⁸³ Vienna Convention on the Law of Treaties art. 2, May 23, 1969, 1155 U.N.T.S. 331. [hereinafter VCLT].

⁸⁴ BEDERMAN, *supra* note 82, at 27-28.

⁸⁵ *See id.* at 27.

⁸⁶ VCLT, *supra* note 83, at arts. 2, 6-18 (defining, in articles 6-18, Part II: the “Conclusion and Entry into Force of Treaties”).

⁸⁷ BEDERMAN, *supra* note 82, at 28.

⁸⁸ *See Treaty Between The United States of America and the Argentine Republic Concerning the Reciprocal Encouragement and Protection of Investment*, US-Arg., Nov. 14, 1991, S. TREATY DOC. NO. 103-2 (1993).

⁸⁹ *Id.* at Art. I.

an “investment dispute.”⁹⁰ Seeing as a bilateral agreement already exists that defines investors’ rights, although not the same rights as would be necessary to aid foreign investors in gaining power of regulating rating of US securities, investors’ rights are possible. However, the US would have to desire to make the treaty, as it did with Argentina, before any rights in foreign investors could ever be assigned.

International organizations such as the UN may offer hope for internationalization of regulation of securities. As stated in the Preamble to the UN Charter (the Charter), one of the goals of the UN is “to employ international machinery for the promotion of the economic and social advancement of all peoples.”⁹¹ Therefore, if the internationalization of securities regulation and rating is considered as a benefit to the world’s economic advancement, the UN would have an argument to take jurisdiction from domestic sources. However, it would be a difficult idea to sell to the US based solely on the Preamble because it means that the US would have to give up some sovereignty. In addition to the Preamble, the UN Charter provided for an “Economic and Social Council” as an organ of the organization.⁹² The Charter further suggests that the UN shall promote “solutions of international economic, . . . problems.”⁹³ Additionally, in outlining the functions and powers of the Economic and Social Council of the UN, the Charter maintains that the “fifty-four members of the UN elected by the General Assembly” comprising the council are entitled to

[1] make or initiate studies and reports with respect to international economic, . . . matters and. . . make recommendations with respect to any such matters to the General Assembly, to the Members of the United Nations, and to the specialized agencies concerned. . . . [3] [P]repare draft conventions for submission to the General Assembly. . . . [4] [M]ay call . . . international conferences on matters falling within its competence.⁹⁴

⁹⁰ *Id.* at Art. VII (defining investment dispute as “a dispute between a Party and a national or company of the other Party arising out of or relating to (a) an investment agreement between that Party and such national or company, (b) and investment authorization granted by that Party’s foreign investment authority (if any such authority exists) to such national or company; or (c) an alleged breach of any right conferred or created by this Treaty with respect to an investment”).

⁹¹ U.N. Charter pmbl.

⁹² *Id.* art. 7, para. 1.

⁹³ *Id.* art. 55, para. b.

⁹⁴ *Id.* art. 61 & 62, para. 1.

Therefore, in arguing for UN jurisdiction over the rating of securities, an example of “international machinery,” as mentioned in the Preamble, could be an international securities regulation system that uses universal criteria for determining the risk ratings of securities, including American securities. Some may argue that the resulting financial state of the world markets, in the aftermath of the subprime mortgage breakdown, is not a large enough economic problem to push the UN to create standards and regulations. However, the repercussions of the failure of the subprime mortgage market seem to be just beginning and could potentially evolve into an economic problem that would have grave effects on investor confidence across the globe.

Currently, no matter the size or the reputation of the news source, all newspapers and other news sources report daily on the subprime mortgage market and its fallout, indicating that there is brewing international economic trouble. From the crash of the subprime market in the summer of 2007 through today, consequences of the subprime mortgage market crisis have led investors to “liquidate[] holdings in a sign of spreading credit turmoil” out of fear that “economic weakness would affect corporate profits, leveraged buy-outs and commercial property.”⁹⁵

Under the realm of the functions and powers of the Economic and Social Council is a related specialized agency whose work with this council may be directed toward internationalization of securities regulation: the World Trade Organization (WTO). The WTO began in 1995 as a successor to the General Agreement on Tariffs and Trade (GATT).⁹⁶ Its functions include “[a]dministering trade agreements” that result from “negotiation between the members” in an effort to keep trade as fair as possible.⁹⁷ Although under GATT, the emphasis of regulation had been on products and commodities, the scope of the WTO was broadened to include the service industry by the General Agreement on Trade in Services (GATS).⁹⁸

Since the WTO no longer only applies to the trade of goods, the WTO could be used as a way to universalize securities regulations and ratings. Thus, it would seem possible for capital markets to enjoy the same principles of “freer and fairer trade” since banks and insurance firms enjoy them.⁹⁹ As the US is considered by many to be “exporting financial products,” it would

⁹⁵ Michael Mackenzie & Henny Sender, *Debt fears heighten in US and Europe*, LONDON FINANCIAL TIMES, Feb. 8, 2008, available at <http://www.ft.com/cms/s/0/2141fb54-d67a-11dc-b9f4-0000779fd2ac.html>.

⁹⁶ World Trade Organization, *The WTO in Brief*, at 3, available at http://www.wto.org/english/res_e/doload_e/inbr_e.pdf.

⁹⁷ *Id.* at 4, 7.

⁹⁸ *Id.* at 4.

⁹⁹ *Id.*

seem that the trade developed by this export system could come under the jurisdiction of the WTO.¹⁰⁰ Additionally, the WTO is charged with dispute settlement for “resolving trade quarrels.”¹⁰¹ However, the WTO does not “purport to regulate” certain areas.¹⁰² Consequently, as securities are not listed as an exception to the WTO’s scope, if the WTO were to take on jurisdiction by qualifying the subprime mortgage market crisis as a trade quarrel, a country could bring a dispute to the WTO concerning foreign investors’ lack of rights over regulation of the rating system for securities in the US. The WTO would be able to consult on the quarrel and to rule on it through a panel of experts.¹⁰³

Although not a treaty creating an international regulatory body for securities, the “Convention on the Organisation for Economic Co-operation and Development” (OECD) could possibly be interpreted to cover this desire by foreign investors or could be considered comparable to what would have to be specifically created to provide for regulation over US securities’ ratings from some body other than the SEC approved NRSROs. The OECD offers a “unique forum where the government of 30 market democracies work together to . . . provide[] a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and co-ordinate domestic and international policies.”¹⁰⁴

Although it began in 1961 in Paris by analyzing policy areas within each member country, globalization has changed the focus of OECD; consequently, the OECD looks at “how various policy areas interact with each other, between countries and beyond the OECD area.”¹⁰⁵ Currently, the structure of OECD is made up of the Secretariat, the Council, and the Committees.¹⁰⁶ Upon request of any of the OECD’s 30 members, staff members of the secretariat do research and analysis that is later used by

¹⁰⁰ Timmons, *supra* note 1.

¹⁰¹ WTO, *supra* note 96, at 5.

¹⁰² BEDERMAN, *supra* note 82, at 150-151 (allowing “trading nations some exercise of discretion for trade restrictions in certain areas or in accordance with special sorts of domestic legislation [and] . . . allow[ing] member States to form customs unions and free-trade areas”).

¹⁰³ WTO, *supra* note 96, at 5.

¹⁰⁴ THE OECD BROCHURE 7, 31 (2008), <http://www.oecd.org/dataoecd/15/33/34011915.pdf> (including the following countries as members: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States).

¹⁰⁵ *Id.* at 9.

¹⁰⁶ *See id.* at 11-12.

representatives of the members in one of approximately 200 committees.¹⁰⁷ The committees offer an exchange of ideas for members on certain issues, and even after committee meetings, the representatives, usually “senior officials from national administrations,” have access to OECD documents over the internet and are able to “exchange information through a special network.”¹⁰⁸

However, the OECD Council, comprised of one representative from each member country and a “representative of the European Commission,” holds all of the legal, decision-making power.¹⁰⁹ Upon a consensus of votes in its annual ministerial meeting, the Council mandates work for the secretariat to accomplish.¹¹⁰ The staff of the secretariat, including some “700 economists, lawyers, scientists and other professionals,” is based in 12 directorates who service one or more committees because the work of OECD is increasingly “cross-disciplinary.”¹¹¹

If the OECD was to be used to create regulation rights of US securities in foreign investors, the relevant directorates to do the work would be The Economics Department and The Directorate for Financial and Enterprise Affairs (DFEA). The Economics Department “provides an overall framework to identify structural priorities needing government attention . . . includ[ing] work on the economic implications of . . . financial market developments, barriers to international trade in services and foreign direct investment.”¹¹² Like the Economics Department, the DFEA tackles “public policy challenges of direct concern to business to enhance economic growth and development, ensure financial stability and promote the effective integration of non-OECD countries in the global economy.”¹¹³ In order to accomplish this task, the DFEA examines trends and makes recommendations on whether and/or how to make national regulations or international cooperation.¹¹⁴

Losses to foreign investors from around the globe, not just from the member countries of the OECD, occurred in part because the NRSROs wrongly assured investors that bundled subprime mortgages were not riskier than bundled regular mortgages when sold as asset-backed securities. Under this argument, the problem with giving these two financial instruments the same rating, when the two do not in actuality have identical risk factors, seems

¹⁰⁷ *Id.* at 11.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *Id.* at 12, 14.

¹¹² *Id.* at 19.

¹¹³ *Id.* at 23.

¹¹⁴ *Id.*

to qualify under the areas of financial market development and foreign direct investment in the Economics Department and financial stability and global economy for non-OECD countries of the DFEA. Thus, to internationalize ratings on securities, foreign investors could try to appeal to their representatives to the OECD. The investors would have to convince a member country to request research and analysis on this topic by either directorate or both through the secretariat to be used in committee, or the member country's investors could push for the member to bring the issue before the Council at its annual ministerial meeting. From there, foreign investors would only be able to hope that the Council "unanimous[ly] consent[ed]" since a "veto from a Council member removes an item from the agenda."¹¹⁵ If the issue passed the Council vote, a ruling on the topic could be binding. Under the Convention for OECD, the Organization may make its decisions binding on all members and may "enter into agreements with [m]embers, non-member States and international organizations."¹¹⁶

In order for a decision like this to take effect though, the US would have to agree before it would be binding on the US because "[n]o decision shall be binding on any Member until it has complied with the requirements of its own constitutional procedures."¹¹⁷ Therefore, to use the OECD, the US would have to give up willingly some of its sovereignty because it would no longer be in complete control of the rating systems for its securities. However, the OECD has had some success in areas somewhat comparable to the ratings systems in that it was an essential part of the creation of and encouragement to use "corporate codes of conduct that attempt to develop a set of standards for multinational firms that can be applied across national borders."¹¹⁸ Yet even with the aforementioned example of work of the OECD, there are still those that criticize its role.¹¹⁹ One argument against the OECD expressed the view that OECD "represents a danger to national sovereignty."¹²⁰ Consequently, since an international system of rating securities would take away some sovereignty in nations, especially the US, the US may not want to allow the OECD to take on the role of creating such a system.

If the UN, the WTO, and the OECD refused to take up the issue of lack of confidence in the securities rating system in the US due to the collapse

¹¹⁵ JAMES K. JACKSON, THE ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, CRS No. RS21128, at 2 (2007), available at <http://www.fas.org/sgp/crs/misc/RS21128.pdf>.

¹¹⁶ Convention on the Organisation for Economic Co-operation and Development art.5, Dec. 14, 1960, 12 U.S.T. 1728, 888 U.N.T.S. 179.

¹¹⁷ *Id.* art. 6(3).

¹¹⁸ JACKSON, *supra* note 115.

¹¹⁹ *Id.* at 3.

¹²⁰ *Id.*

of the subprime mortgage market or saw the issue as outside of each of their scopes, a separate international organization could be created. However, a project of that magnitude would not be taken on lightly as these organizations have taken decades to achieve the power and respect they have today. Since the problems created by the subprime mortgage market are still new, although they seem to be increasingly daily, a long, drawn-out treaty writing and ratification process seems unlikely. It is more likely that proponents of change would try to go through the existing channels by finding a way that this problem could fit within their given power rather than charting a new path.

2. Customary International Law

A second well-respected source of international law that could possibly be used to create rights in foreign investors is customary international law (“CIL”). As there is no “inherent hierarchy” between CIL and treaties in terms of the value of the source, a rule may “develop through a parallel evolution in both treaties and customs.”¹²¹ According to the Restatement (Third) of Foreign Relations, Section 102, customary international law “results from a general and consistent practice of states followed by them from a sense of legal obligation.”¹²²

Thus, there is both an objective prong and a subjective prong in deciding whether a practice is CIL. The objective prong is the State practice part of the Restatement’s definition, and the subjective prong then concerns the sense of legal obligation felt by the State.¹²³ CIL allows actors in the international legal field to “informally develop rules of behavior, without the necessity of resorting to more formal and difficult means of law-making.”¹²⁴ The actors that CIL traces include: “States, international institutions, transnational business organizations, religious and civil groups, and individuals involved in international matters.”¹²⁵ Thus, the foreign investors qualify as competent actors to create CIL because they could be classified as transnational business organizations or just individuals where the international matter in which they were involved would be foreign investment.

A classic way in which to understand how international custom becomes international law comes from an American case that is over a century old: *The Paquete Habana*.¹²⁶ This turn-of-the-twentieth century US Supreme Court case involved two fishing vessels that were taken as prizes of war by the

¹²¹ BEDERMAN, *supra* note 82, at 30.

¹²² RESTATEMENT (THIRD) OF FOREIGN RELATIONS §102(2) (1987).

¹²³ See BEDERMAN, *supra* note 82, at 16-17.

¹²⁴ *Id.* at 16.

¹²⁵ *Id.*

¹²⁶ See *The Paquete Habana*. *The Lola*, 175 U.S. 677 (1900).

US during war with Spain.¹²⁷ The vessels were later sold, but the case turns on whether it was against CIL for the fishing vessels to have been captured since there is a practice that “coast fishing vessels, pursuing their vocation of catching and bringing in fresh fish, have been recognized as exempt, with their cargoes and crews, from capture as prize of war.”¹²⁸ After extensive writing on the history behind the practice, including treaties and King’s orders from as far back as the fifteenth century, the Court held that “[v]essels belonging to citizens of the enemy state, and devoted to fishing along the coasts cannot be subject to capture” as long as those vessels did not qualify under the two exceptions offered where the vessel has either been used for a “warlike purpose” or “devoted to the great fishery in the ocean.”¹²⁹ Although the holding shows a preference for maintaining CIL in the US, this is a domestic court ruling on international law. It is not creating international law for any other State besides the US, and additionally, the rule it offers is a very narrow one.

Therefore for foreign investors to use CIL to create rights in regulation over how US securities are rated so that they better understand the risk involved, the interested investors would have to show in a US court that the custom of international rating of securities has been widely practiced by States and that the practice has caused a sense of legal obligation to develop. The investors would have to present evidence concerning the State practice including things like treaties that are on point. As previously discussed, there is no treaty stating that investors of foreign countries have any rights concerning rating the securities of US financial markets, so the evidence would seem to be difficult, if not impossible at the current time, to find.

CIL takes years to develop so that general acceptance of the practice and a sense of legal obligation has time to develop. For example the opinion of the aforementioned case, *The Paquete Habana*, delved into centuries of practice and legal obligation as evidence of CIL.¹³⁰ There is no such evidence of CIL on this topic because the global economy is a developing concept. Although eventually internationalized securities ratings may rise to the level of CIL because the concept may be narrow enough and the practice may develop, in part as a consequence of to the current crisis of US and foreign markets due to subprime mortgages, there does not exist now any customary international law on the topic. Even though CIL is a respected source of international law, it is unable at this time to be used by foreign investors to achieve their goals in US securities markets. However, if investors began to harness support to

¹²⁷ *Id.*

¹²⁸ *Id.* at 686.

¹²⁹ *Id.* at 707-708.

¹³⁰ *See id.* at 686-694.

create a general practice of making the ratings systems for securities international and the US disliked the practice, the US would have to actively try to avoid following the practice because CIL will become binding on actors that fail to object.¹³¹

3. Regulatory Regimes

The final source of transnational law discussed in this paper is regulatory regimes which in comparison to treaties and customarily international law are considered to be relatively new. Currently there is no international regulatory regime governing the rating of securities, yet a regulatory regime that has shown promise in the area of banking may imply that an international regulatory regime would be a way for foreign investors finally to be a part of rating securities on US markets. Created by the Bank for International Settlements, an international organization in its own right, “in the aftermath of serious disturbances in international currency and banking markets,” this model regulatory regime is known today as the Basel Committee on Banking Supervision (the Committee or the Basel Committee) and was founded as the Committee on Banking Regulations and Supervisory Practices.¹³²

Originally, in 1974, the members of the Committee were the “central-bank Governors of the Group of Ten countries.”¹³³ Currently though members come from countries including: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, United Kingdom, and United States.¹³⁴ In 1988, the Committee responded to “the overriding need for a multinational accord to strengthen the stability of the international banking system and to remove a source of competitive inequality arising from differences in national capital requirements” by introducing “a capital measurement system” known today as the Basel Capital Accord.¹³⁵ The Basel Accord “provided for the implementation of [a] framework with a minimum capital ratio of capital to risk-weighted assets of 8 percent by end-1992.”¹³⁶ In the twenty years since the implementation of the Basel Accord,

¹³¹ BEDERMAN, *supra* note 82, at 30.

¹³² Bank for Int’l Settlements, History of the Basel Committee and its Membership, at 1, *available at* <http://www.bis.org/bcbs/history.pdf> [hereinafter Bank for Int’l Settlements].

¹³³ *Id.*

¹³⁴ *Id.*

¹³⁵ *Id.* at 2.

¹³⁶ *Id.*

member countries and “virtually all other countries with active international banks” have implemented its regulations.¹³⁷

Since the Committee “does not possess any formal supranational supervisory authority,” its regulations are considered to be non-binding, “soft law.”¹³⁸ However, “soft law” has had a “tendency, over time, to harden into international legal obligation.”¹³⁹ With the reliance by so many countries on the original regulations offered by the Committee and with the continued loyalty to the Committee by countries “working to adopt the Basel II text through domestic rule-making and approval processes,” it seems that the regulatory regime created by the Committee has become a well-respected source of international law.¹⁴⁰ Thus, it would seem that a regulatory regime resembling that of the Basel Committee on Banking Supervision may work for the regulation and rating of securities as “there has been no successful effort at international harmonization of the regulation of securities transactions.”¹⁴¹

To create a regulatory regime like that of the Basel Committee, foreign investors wishing to create the international system would need to enlist the help of the States in which they are domiciled. Once there was State support of the idea, the States would then have to come together to make decisions about the definition and scope of the regime. One of the first decisions to make would be what governmental body would act as the representative to the regime since on the Basel Committee the central bank of each member and the corresponding governmental authority of the banking business represent their respective member country.¹⁴² The next issue before the potential member countries would be to discuss the scope of the proposed regime. The Basel Committee has as its purpose to “encourage[] convergence towards common approaches and common standards without attempting detailed harmonisation of member countries’ supervisory techniques.”¹⁴³ To achieve this goal, the Committee makes sure that its guidelines are broad enough such that “no foreign banking establishment should escape supervision; and that supervision should be adequate.”¹⁴⁴ A regulatory regime

¹³⁷ *Id.*

¹³⁸ *Id.* at 1.

¹³⁹ BEDERMAN, *supra* note 82, at 100.

¹⁴⁰ See Bank for Int’l Settlements, *supra* note 132, at 3.

¹⁴¹ Roberta Romano, *The Need for Competition in International Securities Regulation*, Address Before The Cegla Institute for Comparative and Private International Law of the Tel Aviv University Law School Conference on Protecting Investors in a Global Economy (June 27-28, 2000), in 2 *Theoretical Inquiries L.* 387, 388 (2001).

¹⁴² Bank for Int’l Settlements, *supra* note 132, at 1.

¹⁴³ *Id.* at 1-2.

¹⁴⁴ *Id.* at 2.

for the internationalization of rating regulation of securities could be established in much the same way. The representatives could be bodies whose current job it is to regulate the ratings of securities such as the SEC with its regulation over NRSROs in the US.

After choosing who the representatives would be, the fledgling regime would then be able to decide whether it wanted to be narrower in its regulation by creating one specific rating system or whether it wanted to follow the lead of the Basel Committee and decide on uniform standards for rating securities that could then be added to member countries' current systems for rating. Part of the success of the Basel Committee seems to be because it has remained broad in its recommendations. By remaining broad in its scope, the Committee has been able to maintain "ongoing collaboration in the supervision of international banks" and has expanded its reach to related topics including: "the obstacles to effective supervision arising from bank secrecy regulations in different countries; . . . [and] overcoming the impediments experienced by banking supervisors in conducting effective consolidated supervision of the cross-border operations of international banks."¹⁴⁵ Thus, if a regime were to be created for rating of securities through international means, the regime should try to formulate standards, guidelines, and recommendations that would be able to be practically implemented by the members. By making the standards something that can be achieved through domestic regulation as well, the regime would not be infringing too drastically on the sovereignty of the members, and compliance would be a more realistic expectation.

Lastly, after the potential members carved out who would represent the members in deliberations, what the regime's goals would be, and how the regime planned to carry out those goals, those potential members would have to create, sign, and put into force some sort of charter "combining the elements of public constitutions and articles of incorporation."¹⁴⁶ The regulatory regime would derive its power from this charter, and the charter would ensure compliance much like the Constituent Charter of the Bank for International Settlements which created the Bank for International Settlements who in turn created the Basel Committee.¹⁴⁷

However, the creation and use of a regulatory regime may not be as well-received as that of the Basel Committee as there are those that criticize centralized international regulatory regimes in favor of competition. One such

¹⁴⁵ *Id.*

¹⁴⁶ BEDERMAN, *supra* note 82, at 66.

¹⁴⁷ See generally Constituent Charter of the Bank for International Settlements, Jan. 20, 1930, 104 L.N.T.S. 441, available at <http://www.bis.org/about/charter-en.pdf>.

critic, Roberta Romano, of the Yale Law School and National Bureau of Economic Research, takes the position that securities regulations should not be internationalized.¹⁴⁸ Instead, she argues that the “absence of a uniform international regulatory scheme is, . . . , a benefit for investors in securities because it allows for some competition among securities regimes.”¹⁴⁹

One benefit under the regulatory competition regime espoused by Romano is a reduction in “the possibility that a regulator will be able to transfer wealth across different regulated entities or redistribute wealth from the regulated sector to preferred individuals or organizations.”¹⁵⁰ This is a benefit because it allows institutional investors the opportunity to avoid “fixed commission rates” which aid individual investors and exchange members by permitting them to switch to a lower cost regulator.¹⁵¹ Another benefit to competition would be that it could correct for policy mistakes faster than a single regulator could because an issuer’s decision to go with one regime rather than another would signify preference.¹⁵² Under this idea, if an issuer did not like a specific policy made by one regulatory body, its choice of another, even though the products were the same, would show the first regulatory body that there may be a mistake in its policy which would in turn inspire change quicker than it would without the competition. A third possible benefit with greater competition among regulation of securities would be innovation.¹⁵³ Under this benefit, no regime would be satisfied with maintaining status quo if that meant that consumers would head to another regime, and the constant evolution would increase the possibility of creating new “products, institutional practices, and legal rules.”¹⁵⁴

Apart from the benefits of competition though is its ability to actually work in practice. Just as treaties or regulatory regimes would need government help to be created so too would a competitive regulatory market.¹⁵⁵ Under a competitive regime, nations would have to give up, or at least change, their “present territorial jurisdictional approach” in favor of a “statutory securities domicile” which would be selected by the issuer.¹⁵⁶ Giving up territorial jurisdiction seems to be a high bar to set in favor of the benefits offered. The bar seems to get even higher if mutual recognition to release territorial jurisdiction for statutory securities domicile can only be “effectuated by a

¹⁴⁸ Romano, *supra* note 141, at 387.

¹⁴⁹ *Id.* at 388.

¹⁵⁰ *Id.* at 392-93.

¹⁵¹ *Id.* at 393.

¹⁵² *Id.*

¹⁵³ *Id.*

¹⁵⁴ *Id.* at 393-94.

¹⁵⁵ *Id.* at 397.

¹⁵⁶ *Id.*

treaty or other executive agreement approved at a higher governmental level than the securities agency.”¹⁵⁷ So it seems that even in competition, there is a need for sources of transnational law.

Thus, whether advocating for greater breadth of regulation to bring all rating standards for securities under one umbrella or for diversifying the way in which securities are regulated so as to achieve economic efficiency, a regulatory regime may be the most likely remedy for foreign investors looking to change the way that securities on US markets are currently regulated.

B. Enforcement in the US Should a Foreign State Domestically Create Rights

Jurisdiction is essential to any case brought before a court or any regulatory body looking to pass a resolution or piece of legislation. It can mean the right to prescribe, the right to adjudicate, or the right to enforce.¹⁵⁸ A nation’s jurisdiction to enforce correlates with its jurisdiction to prescribe rules “that impact the conduct and behavior of individuals outside the United States” and its jurisdiction to adjudicate “a matter involving a foreign national or events that transpired beyond that country’s borders.”¹⁵⁹ If a foreign State were domestically to create a piece of legislation concerning the rights of its investors in reference to US securities or if an individual or State to bring a case against the US in the US for losses sustained due to the collapse of the subprime mortgage market, the right would not be respected until enforcement in the US had been demonstrated. Yet enforcement is not a concept that is unique to the United States. “[M]uch of international law depends for its success on enforcement through national legal systems.”¹⁶⁰

1. Comity

The word “comity” has several meanings that are unique to the context in which it is used. Among those contexts is that of enforcement of foreign legislation or judgments when there are “conflicting claims of State jurisdiction and power.”¹⁶¹ Determining whether a court will enforce a judgment by using comity is the traditional approach. Thus, comity in this sense is best defined by a late 19th century US Supreme Court case, *Hilton v. Guyot*, as

¹⁵⁷ *Id.* at 398.

¹⁵⁸ See BEDERMAN, *supra* note 82, at 180.

¹⁵⁹ *Id.*

¹⁶⁰ *Id.* at 157.

¹⁶¹ *Id.* at 181.

neither a matter of absolute obligation, . . . , nor of mere courtesy and good will, . . . it is the recognition which one nation allows within its territory to the legislative, executive, or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens, or of other persons who are under the protection of its laws.¹⁶²

In *Hilton*, the action arose because a French liquidator was trying to recover from a judgment which was awarded in a French court in Paris against citizens of the US who had been in business in Paris but had since left France.¹⁶³ Although the French proceedings and judgment were not denied by the Americans in their answer to the complaint, they did assert that they “had no property within the jurisdiction of France out of which that judgment could be collected.”¹⁶⁴ After a thorough discussion of comity and the practices of other jurisdictions for enforcing judgments, the Supreme Court held the judgment to be inconclusive because of the rule of reciprocity, the rule that a judgment “in a foreign country is allowed the same effect only as the courts of that country allow to the judgments of the country in which the judgment in question is sought to be executed.”¹⁶⁵ Although the rule of reciprocity is not widely used presently, at the time, the Supreme Court did not believe France would have honored a US judgment, so it did not enforce the French judgment. If the US only used this rule for interpreting cases, it would only enforce judgments from jurisdictions that enforce US judgments meaning that comity, or deference, would only be shown to certain jurisdictions.

To illustrate *Hilton’s* holding, imagine a foreign investor domiciled in Britain lost a large sum of money after relying on his or her investment firm’s, a New York based firm with no assets abroad, advice to purchase subprime mortgage-backed securities in the US during the housing boom of 2005. If that same investor then brought an action under British law and in Britain against the investment firm and a British court proceeded to award judgment to the British investor, would that judgment be enforced in the US when the investor tried to collect on it? If the holding of *Hilton* is taken into account, the main question for the court listening to the case in the US is whether the U.K. shows the same deference to American judgments that are looking to be enforced abroad. Thus, since comity between the US and UK is generally accepted, the British investor could prevail. However, comity, and specifically the rule of reciprocity, is not the only thing used to decide in a case such as that presented

¹⁶² 159 U.S. 113, 163-64 (1895).

¹⁶³ *Id.* at 114.

¹⁶⁴ *Id.* at 116.

¹⁶⁵ *Id.* at 227.

in the above example. Whether a case, such as the one hypothesized, would be enforced in a US court would depend on factors used in addition to comity.

In actuality, comity does not experience unanimous praise anymore, so it may aid a foreign investor trying to collect on a foreign judgment in the United States.¹⁶⁶ One case from the early 1990's, *Hartford Fire Ins. Co. v. California*, represents the chagrin for the use of comity when a foreign government may allow behavior that the US does not.¹⁶⁷ In this antitrust suit in which the use of the Sherman Antitrust Act on foreign reinsurers is a part of the argument, nineteen states as well as private parties sued domestic insurers, domestic and foreign reinsurers, and insurance brokers because of their alleged engagement in "various conspiracies to affect the American insurance market."¹⁶⁸ In the portion of the opinion dealing with comity, the Supreme Court held in a 5-4 vote that "international comity does not preclude District Court jurisdiction over the foreign conduct alleged."¹⁶⁹ By holding such, the Court was allowing a US court to exert jurisdiction over a foreign company. To the majority, the "substantial question . . . [was] whether 'there [wa]s in fact a true conflict between domestic and foreign law.'"¹⁷⁰ Although the London reinsurers tried to argue that the application of the Sherman Act by the Court would "conflict significantly with British law," the majority was not persuaded.¹⁷¹ The Court did not find conflict because the London reinsurers could have complied with both British and American law.¹⁷² Under this rationale, comity is not immediately presumed. Instead, a foreign party (such as an investor) looking to enforce a foreign judgment in the US under comity principles would have to show that the foreign law required the US party (such as an investment firm) "to act in some fashion prohibited by the law of the United States."¹⁷³ Consequently, with the ever-evolving global economy, laws do not seem to conflict as often as would be necessary for a comity argument to work.

¹⁶⁶ BEDERMAN, *supra* note 82, at 182.

¹⁶⁷ 509 U.S. 764 (1993).

¹⁶⁸ *Id.* at 764, 769.

¹⁶⁹ *Id.* at 766, 770.

¹⁷⁰ *Id.* at 798 (citing *Societe Nationale Industrielle Aerospatiale v. US Dist. Ct. for Southern Dist. of Iowa*, 482 U.S. 522 (1987)).

¹⁷¹ *Id.* at 798-99 (citing RESTATEMENT (THIRD) FOREIGN REL. LAW §415, cmt. j, "the fact that conduct is lawful in the state in which it took place will not, of itself, bar application of the United States antitrust laws").

¹⁷² *Id.* at 799.

¹⁷³ *Id.*

2. Enforcement of Foreign Judgments

Although there have been no cases as of yet from other countries or their nationals concerning the collapse of the subprime mortgage market in the United States, the consequences of the collapse have not yet been fully realized. Since confidence seems to drive the securities markets, investors, both foreign and American, must regain that feeling about the way in which the securities that are being sold to them are rated. Until that confidence is regained, there is a chance that US courts will see complaints filed by foreign investors looking to either recover directly through the US court system or looking to have a foreign judgment enforced. As investors are probably more likely to bring cases in their home States for reasons such as cost or convenience, foreign judgment enforcement may be a way for the investors to assert the rights they do have to make a change in the US securities markets. Additionally, by asserting their right to litigate, foreign investors may also inspire change more quickly than through an international organization or the creation of a treaty.

An important part of the formerly discussed *Hilton* case came in the dicta of the case which created a nine-element test for enforcement of foreign judgments that is still used currently.¹⁷⁴ Under this test, if there is no treaty on the subject of the judgment, a judgment will be enforced if there has been an a

[1] full and a fair trial abroad [2] before a court of competent jurisdiction, [3] conducting the trial upon regular proceedings, [4] after due citation or voluntary appearance of the defendant, . . . [5] under a system of jurisprudence likely to secure an impartial administration of justice between the citizens of its own country and those of other countries, . . . [6] nothing to show prejudice in the court, . . . [7][nothing to show prejudice] in the systems of laws under which it was sitting, . . . [8] [no] fraud in procuring the judgment, . . . [9] any other special reason comity . . . should not allow it full effect.¹⁷⁵

Under this rationale, the *Hilton* case would have likely come out differently because it seemed to satisfy the test above, but at the time it was decided reciprocity was the overruling factor. This test implies that a judgment garnered for a foreign investor from a foreign court will be presumptively enforceable because the US likes to have its judgments enforced abroad. In addition to the option of using the *Hilton* test, the Uniform Foreign Money

¹⁷⁴ *Hilton*, *supra* note 162, at 202-203.

¹⁷⁵ *Id.*

Judgments Recognition Act (UFMJRA) has been adopted by 30 states, the District of Columbia, and the US Virgin Islands as the guide for foreign judgment enforcement.¹⁷⁶ The UFMJRA, as stated in §2 of the Act, “applies to any foreign judgment that is final and conclusive and enforceable where rendered.”¹⁷⁷ Additionally, the UFMJRA offers both mandatory and discretionary instances in which the foreign judgment is either not conclusive or “need not be recognized,” respectively.¹⁷⁸

Therefore, if a foreign investor were able to gain a money judgment that it was looking to have enforced in the US, a court would have the option to use the *Hilton* test or the UFMJRA to decide whether it is enforceable, depending on the jurisdiction in which the court sits. As mentioned earlier in this section, enforcement of foreign judgments may be a quick way for investors to institute change in the US securities markets because if, for example, investment firms have to pay out judgments, whether they be large or small, the firms may look more closely at the risk of the investments they are selling if they are losing money and having to defend themselves in civil actions.

A contrary assumption to that espoused above, that investors may see foreign judgments as a way to bring attention to the allegedly unfair or unrealistic ratings of US securities, may be that foreign investors do not want to settle these issues on a case by case basis. Instead, they may desire to have a set of rights created for them or an international rating system that would help them to invest their money better. Although that desire may be much easier to dream than to actually come to fruition, court fees can become very expensive, so foreign investors would have to weigh the costs and benefits of trying to change the system through foreign judgments before actually bringing suit.

III. CONCLUSION

As globalization has rapidly made the business world flat and accessible to almost anyone with a computer, the creation of an international rating system for securities seems to be a plausible and beneficial objective. In the wake of the subprime mortgage collapse and constant questions about hedge funds, countries like France and Germany have already indicated that they want more international regulation.¹⁷⁹ However, the idea of an international rating system is not a new one. During the late 1990’s, an Asian

¹⁷⁶ ALASKA STAT. §9.30.2 (2008)(offering table of jurisdictions in which the Act has been adopted).

¹⁷⁷ UNIFORM FOREIGN MONEY JUDGMENTS RECOGNITION ACT §2 (Nat’l Conference of Comm’rs on Uniform State Laws 1962).

¹⁷⁸ *Id.* §4.

¹⁷⁹ Timmons, *supra* note 1.

financial crisis encouraged “President Bill Clinton and a number of regulators and politicians [to] push[] to remake the global financial system. But the impetus faded as markets stabilized.”¹⁸⁰ In addition to trying to make the rights before the anger and hurt subside over the current mortgage crisis, like it did in the late 1990’s, creating these rights may be more easily said than done.

Sources of transnational law, including the treaties, international organizations, customary international law, and regulatory regimes discussed earlier all have benefits and costs that would have to be weighed before action could be taken. One of the major costs to be considered is that nations, like the US, who have securities regulations in place, may not be willing to give up sovereignty in order to make it easier for foreign investors to invest in their markets. If foreign investment does not change, nations like the US have no incentive to alter their practices, and only time will tell if foreign investors will pull their money out of US markets. Additionally, a desire for competition among markets and regulatory regimes may be an aspiration that leads State actors away from creating an international rating system or setting international standards for rating securities. Lastly, trying to carve out investor rights by bringing judicial actions may be both time consuming and impractical. Thus, although foreign investors would like to see more regulatory rights, the consequences of the collapse of the subprime mortgage market will likely have to become much worse in order for change to be inspired.

¹⁸⁰ *Id.*