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Standardisation by law and markets especially in financial services

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Abstract

Standardisation techniques are used in a very broad range of financial transactions: technical standards, model contracts, codes of conduct, accounting rules, and even experiments with alternatives to European regulations. Especially in the financial services field, where mass production and relational stability are essential, standardisation is an integral part of the existing framework and its regulation. The functions of standardisation are manifold and extend even to issues like mutual recognition. The relationship of these techniques with the legal system is a complex one, relying on a wide range of instruments such as contract provisions, explicit references in the law, default rules, good business practices, and so on. Enforcement is partly based on legal instruments, but also on the market.

Standardisation by law and markets especially in financial services

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Introduction

1. The concept of standardisation may, depending on the angle chosen, be limited to technical standards used in numerous technical appliances, or cover an extremely wide range of subjects, techniques, and forms, whereby human conduct is streamlined, or "standardised". Within this broader field, the present analysis will be limited to standardisation in the financial sector, the latter to be understood as covering financial transactions, or conduct rules applicable to financial intermediaries and including stock exchange listed companies. In the financial sector standardisation under its different appearances has been at work for a long period of time, and is increasingly touching all fields of financial business. Also, it is *par excellence*, a field where law, regulation, contractual arrangements and other forms of legal and quasi legal instruments have been combined to create a reliable system, but also where market forces have by themselves created a drive for standardisation that have resulted in legal or quasi legal instruments. Therefore looking at the breadth of the subject there is definite danger of losing focus.

1. Standardisation

2. In a narrow sense, standardisation could be understood as techniques used to streamline conduct of market participants by referring to clearly predefined instructions. Here one sees technical standardisation e.g. for electrical appliances, realised by the European Committee for Electrotechnical Standardisation[1]. More sophisticated are standards used for telecommunication, which due to their international character have a tendency to become worldwide in their acceptance. The ISO standards currently used in financial messaging services – operated by SWIFT[2], the worldwide financial messaging system – are examples of a successful worldwide standardisation. In these cases the use of the standards is imposed by the markets: nobody can transmit any message if he does not adhere to the ISO standard, and the sanction is de facto exclusion from the market. In legal terms these standards are embedded in contractual obligations creating a network of worldwide contractual relations. There are several other similar examples relating e.g. to payment cards, to cross border payment orders (e.g. IBAN[3] or ISIN[4] numbers, for payments or for securities identification). The use of some of these codes have been imposed or recommended for international financial transactions.

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1 See http://www.cenelec.org/Cenelec/About+CENELEC/default.htm. Cenelec describes its legal position as follows: "A Resolution of 7th May 1985 of the European Council formally endorsed the principle of reference to European standards within the relevant European regulatory work (Directives), thereby paving the way to a New Approach in the philosophy of regulations and standards in Europe. In the light of this New Approach, CENELEC is developing and achieving a coherent set of voluntary electrotechnical standards as a basis for the creation of the Single European Market/European Economic Area without internal frontiers for goods and services." The site also contains an elaborate description of a "standard". Cenelec is a non-profit organisation set up under Belgian law.

2 See on SWIFT in general: http://www.swift.com/index.cfm?item_id=43232; for the Swift standards, see http://www.swift.com/index.cfm?item_id=60395. These standards play an important role in the integration of the markets and in the European harmonization.

3 IBAN or International Bank Account Number was started in 1997 by the International Standards Organisation ISO and later promoted by the European Committee for banking Standards. In addition there is the BIC code or Bank Identifier Code, often referred to as the SWIFT code.

3. A less technical, and therefore less strictly binding form of standardisation will be the result of the use of non-regulatory standard agreements. The best examples here are the Uniform Rules on Letters of Credit[5] or on bank guarantees[6], established by the International Chamber of Commerce[7]. These framework contracts are established by market practitioners and constitute the state of the art in the field they cover. Although not mandatory for the contract parties, they are accepted on a worldwide basis and are used as the standard reference for that specific type of contractual relationship. However, they are not binding per se: a reference in the contracts of the parties concerned is necessary to make the uniform rules binding. Only if parties explicitly stipulate will the effect of certain provision be waived. In practice however, as these rules are so widely used, it would be difficult for an individual market to refuse to adhere to the Uniform Rules, as this is likely to jeopardise his commercial business deal. Cases or interpretations, rendered in one state will be considered authoritative in other jurisdictions These standard contracts create some form of standard law, sometimes referred to as the "Lex Mercatoria"[8]. Here the markets rule.

4. One step higher on the scale, one may encounter instruments that have been elaborated by an international group of regulators and are considered applicable due to their acceptance as a market reference. The CPSS-IOSCO Standards on Clearing and Settlement[9] have been drawn up by a committee of representatives of the central banks and of the securities regulators, acting within the framework of the Basel Committee and the Bank for International settlements. They contain a series of elaborate rules aimed at a wide set of objectives, among which the avoidance of risks is paramount. These Standards contain organisational rules – such as a reference to the ISO standard - but also provisions that may indirectly affect the legal position of market participants, e.g. as spelling out good practice which would be considered as the yardstick for determining liability. These international standards are not legally binding as such although there is a moral obligation for supervisors in the banking and securities field to have these standards implemented in their national legal order. The International Monetary Fund, acting within the framework of its Financial Sector Assessment Programmes (FSAP) uses these standards to check whether a national jurisdiction has implemented the standards and hence is offering sufficient guarantees to market participants both domestically and on cross border basis. If the assessment would be negative, the IMF's opinion will be published, with negative effect on the risk assessment of market participants dealing with firms that have not implemented the standards. Apart from an additional risk premium, political and reputation damage would be inflicted on the markets where these standards were not effectively applied. Here again, enforcement is mainly market led.

5. A comparable but much more ambitious form of standardisation has been developed in the field of the international accounting standards (IAS). The accounting standards are established by the International Accounting Standards Board, or IASB, a voluntary organisation without national regulatory status, composed of experts from around the world. The standards have

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4 International Securities Identifying Number, as defined in ISO 6166. Numbers are attributed by the National Numbering Agencies. ISIN numbers allow all securities to be designated by a single number.

5 ICC Uniform Customs and Practice for Documentary Credits, UCP 600 (new edition July 2007). The text of the UCP 600 is protected by the ICC's copyright.

6 ICC uniform Rules on Demand Guarantees.

7 Established in Paris and involved in a broad range of issues relating to international trade and business: The ICC developed the Incoterms, and many model contract clauses: see http://www.iccwbo.org/policy/law/id272/index.html

8 See F. de Ly, International Business Law and Lex Mercatoria, Amsterdam 1992.

9 See BIS, Recommendations for securities settlement systems CPSS Publications No 46 November 2001.

been mandated in Europe on the basis of an EU regulation[10], and after a procedure of "endorsement" whereby the European Commission decides on the applicability in a Commission Regulation. Usually the Commission adopts the entire proposed standard, although in some highly exceptional cases, a temporary exception was adopted[11]. After that the individual International Financial Reporting Standards or IFRS become directly binding on all listed companies. Recently the US authorities have published for comments a plan to adopt the IFRS also for domestic purposes, while India and China are likely to sign up to the IFRS. In that case, accounting rules would be standardised on a worldwide basis.

6. Corporate governance is a field where national laws, traditions and approaches dominate. It is generally accepted that there is no single uniform best way to organise the governance of a large listed company. Nevertheless, companies, board members, securities markets and governments have felt a strong need to streamline their governance concepts, essentially in corporate governance codes. The governance codes may stand for yet another step on the ladder of decreasingly strict standardisation. These codes are essentially national and have been drawn up by committees of very different nature. The codes are sometimes rendered applicable pursuant to a provision in the national laws, or more generally on a voluntary basis. But the days of a purely voluntary approach are numbered. In the future, due to a European directive[12], the national laws will have to contain a provision urging all companies to indicate which code they consider applicable to them[13]. Even today, although the codes are voluntary, they are usually considered binding upon the listed companies under the pressure of the markets. These pressures come not only from the stock exchanges authorities but more strongly from the rating agencies, the institutional investors, the voting agencies, the financiers, the governance advisers, the press and the public opinion at large. Companies that would not pay any attention to the provisions of the codes would probably be stigmatised as "suspect" in governance terms. Therefore most of the codes rely on a disclosure requirement, whereby the board is expected to explain whether or not it complies with the code, and if not, for what reasons. This "comply or explain" mechanism serves as a market driven enforcement tool, resulting in market driven sanctions, mainly in terms of reputation damage, and sometimes in more or less voluntary resignation. There is a debate about the involvement of the market supervisors in the enforcement the provisions of the corporate governance codes. In very few states, securities supervisors have been put in charge of reviewing the code, and their supervision is more linked to the formal disclosures than to the substance of the disclosed information.

The trend to attempt to capture some undesirable conduct in conduct of business rules has always been very characteristic of the London City. The strongest example is that of the City Code on take-over and mergers, that has governed takeovers in a most efficient way for more than forty years, and this without any express legislative underpinning. Recently another code was proposed dealing with the criticism that private equity firms were too secretive about their transactions.[14]

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10 IFRS and their predecessor IAS (International Accounting Standards). The IFR have been declared applicable to listed companies in Europe by the Regulation 1606/200 of 19 July 2002 "on the application of international accounting standards". In addition, Member states may declare the IFRS applicable to the consolidated or other accounts of companies other than listed ones.

11 IFRS 32 and 39 where a temporary "carve out" was admitted after a very intensive debate.

12 Art. 46 a, 4th Company law directive, as amended by directive 2006/46.

13 This is the regime that the law introduced in the Germany and in the Netherlands: for details: see Wymeersch, The enforcement of corporate governance codes, Journal of Corporate Law Studies, 2006, 113; also: Corporate Governance and the Codes of Conduct, Deutsche Gesellschaft für Rechtsvergleichung, 2007.

14 M. Arnold, Buy-out Code could "name and shame", FT, August 1, 2007, at 2, referring to a code of conduct proposed by sir David Walker.

7. An even more lax technique of standardisation could be found in the field of disclosure. Much of the regulation in the securities markets is based on disclosure of the relevant facts, so that investors can make up their minds. This information is supervised by the securities supervisors, who however will not give an opinion on the substance of the information, nor on the quality of the investment offered. Standardisation of this information has been achieved through different avenues. For prospectuses used in connection with the public offering of securities, the standard scheme has been laid down in a EU regulation. However, in addition to the information imposed by this regulation, banks will often insist on having additional information that is likely to protect them against claims from investors. These information items have become increasingly comparable, if not uniform due to international market practice. A good example is the listing of the "risk factors", in fact a long list of all imaginable events that could affect the value of the securities on offer. The practice, which is now fairly general also in domestic transactions, has been imported by the international law offices and corresponds to the practices developed in the US since several years. Liability suits are indeed more frequent in the US than in Europe where they are – Germany probably excepted – rather rare. This streamlining of practises extends to the transactions themselves: where up to ten years ago, the issuer of securities had at least in some jurisdictions, to state how he arrived at the price for the securities proposed, today that price would be established in an auction like procedure, called "bookbuilding". The procedure has been developed out of practice, and is fairly standardised.

8. In 2006 the European Commission decided to try out a different approach to hard regulation, by requiring the market participants in the field of market infrastructure – securities trading, clearing and settlement - to agree to a Code of Conduct. The objective of this initiative was to bring these firms to agree to a scheme of liberalisation and transparency that would reduce the considerable costs of cross border securities trading in Europe. Therefore the action concerned not only a heterogeneous population, but also several policy lines within the Commission especially securities regulation and competition. After all firms active in the said fields had signed up to the Code, elaborate negotiations took place among the market participants under the sharp eye of the Commission to propose plans for introducing transparency in the fee schedules, for allowing free access to different trading, clearing or settlement platforms and finally avoid cross-subsidisation between the different functions. Although the implementation of the Code is still in progress, it seems that its objectives will be achieved. The willingness of the firms is also largely due to the fear of many to avoid more forceful intervention of the Commission, whether by proposing a directive, or pursuing actions in the field of competition[15]. Commissioner McCreevy has announced that if the code of conduct approach would prove to be successful, he might consider to apply it in other fields, especially those where players with multiple interests and from different business activities are involved[16].

2. Standardisation, self-regulation and soft law

9. Although these three concepts refer to different issues they are in practice often interrelated. Standardisation in its strong form is most clearly met in the field of technical standards. The notion of standard has then a double meaning, one of a technical instruction subject often to complex normalisation procedures, implying some type of self-regulation, and that of benchmark, of reference point for certain recommended conduct. The concept of "standard"

[15] One investigation was undertaken with respect to Clearstream but did not lead to a sanction; http://europa.eu/rapid/pressReleasesAction.do?reference=IP/04/705&format=HTML&aged=0&language=EN&guiLanguage=en

[16] McCreevy, Speech O6/659 Nov 7, 2006.

may also refer to an instruction that is not legally binding, but is stronger than a recommendation[17]. Self-regulation is a complex notion indicating that the addressees of the regulation have been responsible for its drafting and its imposition. Often self-regulation aims at establishing standards – in the softer sense – voluntarily adopted by the addressees, or imposed on those willing to exercise a certain activity or to engage in certain transactions (ICC model contracts). Self-regulation can also adopt numerous variations going from self-imposed conduct – as in many corporate governance codes – to conduct imposed upon access to a market, to finally regulation backed by government order[18]. But in any case, self-regulation is characterised by the fact that its content is always determined by its addressees, usually without interference from the public authorities. Soft law is a more general and very broad concept referring to rules – often self-regulatory standards or recommendations – that are outside the enforcement zone of the public authorities and therefore are not sanctioned by the instruments used by the state to enforce its orders. In many cases, enforcement of soft law rules, and therefore of some of the standards and instruments of self-regulation is take up by market forces, an efficient alternative to public enforcement instruments for matters that do not belong to the core of the state public order.

3. Standardisation by the law and by the markets

10. Standardisation, in the sense understood in the preceding paragraph takes place within the legal system, is supported by it and this in the domains left open by the legal system. It cannot exist in contradiction with the legal system, but supplements it in field that the legal system has not yet considered, or does not want to enter into. This illustrates that there is a permanent tension between the legal system and the rules that are analysed here.

The role of the markets in the standardisation process is determined by the freedom that has been left by the legislator: in that sense there is an interplay between the law, as the instrument for government intervention and the market forces, that guide action in the fields left by the legislator. The markets' role shows up both at the level of initiating action, formulating its content and ensuring its implementation.

11. National legislation will often contain rules of enabling other institutions – government agencies, more rarely professional organisations e.g. - to enact standardised rules. The law will provide that technical standards will be enacted by subordinate bodies such as the national "normalisation" bodies[19]. It will depend on national legislation whether these standards will be applicable by virtue of the law, or whether a contractual reference, or a general reference in the national law to "good business practice" or to the "rules of the trade" will give sufficient authority to confer them legal force. European law has of course been very instrumental in developing extensive rules that aim at standardising products, transactions, conduct, etc. This European action continues to be essential in opening the markets and creating the vast economic area in which we now live. The Union approaches these issues both in terms of creating the internal market and increasing competition.

12. Private contracts – here seen as part of the law – are the entry point for uniformisation developments in specific fields. A model set of provisions (e.g. the standard "Uniform Rules

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[17] The Committee of European Securities Regulators has published a statement clarifying the meaning of the different instruments it adopts at the level 3.

[18] The corporate governance codes in Germany and the Netherlands nt. 13.

[19] DIN or Deutsches Institut für Normierung is probablably the best known normalisation institute. It was founded in 1917 as a private association and has since exercised a very significant influence on normalisation throughout the world: see http://www.din.de/cmd?level=tpl-home&contextid=din

on letters of Credit, established by the International Chamber of Commerce) are rendered applicable to the parties but only by explicit reference in their commercial contracts[20]. Very often, other kinds of contracts will contain references to technical standards as an abbreviated way of defining part of the obligations of the parties: references to the ISO standards are an essential part of international financial messaging as operated by SWIFT. Although very technical these standards and the accompanying standard contract conditions precisely define the position of the parties, and their liabilities. Securities are generally defined by code (the so-called ISIN codes), to which the contract parties make reference to avoid misunderstandings about the security traded[21]. Financial transactions both cross border and domestic are governed by a series of standard contracts that have been designed by London professional organisations.

The code of conduct for securities clearing and settlement mentioned supra nr. 8 also takes part of the group of contractual standardisation techniques, obliging signatories to elaborate a certain number of agreed policies. Technically the agreement is of a contractual nature, but its political content and purport is more important than its value as a contract; however enforcement would take place by market mechanisms (reputation, exclusion).

13. In some cases, the standards or conduct rules are part of the rules of an association in which the members of a particular profession or trade take part. In these cases the rules of the association would determine the binding force of the standards, and violation may result in sanctioning by the association: disciplinary sanctions – such as blame, public "name and shame", suspension of voting rights, expulsion are the traditional legal instruments. If membership – e.g. of stock exchange - is a prerequisite of access to a particular market segment, the spur will be stronger, although possible tougher measures will apply when the exchange acts as a delegated authority[22].

14. The legal force of some of these soft law instruments may depend on the liability risks attached to their violation. Indirectly the legal order, mostly under the form of civil or professional liability, will support provisions of these standards by considering that the standard stood for the right conduct, for the "state of the art", corresponded to the conduct expected from a "honest businessman" or from a "prudent director". Corporate governance codes have been considered in court to illustrate whether a given conduct is acceptable or not[23]. The judge could use the code provision as a yardstick against which to measure the acceptability of the conduct discussed.
This phenomenon of absorption of soft law by the legal system can take place in many ways: liability and general duties of care are the usual entry points, but contract interpretation or any other blank norm[24] can serve the same purpose. This process does not confer legal status to the soft law content in se: the decision always depends on the court. Indirectly however, and due to the legal precedents, certain soft law rules may become part of the generally accepted law.

15. "Standardisation by the market" is a more difficult, and rather impalpable subject. It refers to the phenomenon that rules are enforced, not as a consequence of their legally binding force,

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[20] There has been some case law declaring these model contracts applicable without contractual reference but these would seem outliers in legal analysis.

[21] These codes are defined by an international organisation in which the American Law Institute has an important stake. They will be used in Europe for insuring the transmission of transaction reports among the market supervisors, pursuant to art. 25 of the Mifid (directive 2004/39 of 21 April 2004).

[22] Several directives accept that the stock exchanges or other private bodies can be involved in the implementation of the directive for limited fields and this on the basis of a delegation in national law: se on the subject: Wymeersch, E. Delegation as an instrument for financial supervision, ssrn, 952952.

[23] Comp. Hoge Raad, 21 February 2003, NJ, 2003, 192, ann. Ma.

[24] Esp. directors' liability; or reps and warranties in contracts.

but due to economic or financial sanctions that may penalise the party that is not abiding by the rules. Indirectly, rules will then be conceived to identify conduct that would be acceptable to the market participants. In a further stage of development, these rules will morph into standards or codes to be more easily identified and enforced. One could cite here the accounting standards, supporting reliability of annual statements: the rules relating to these subjects may be enforceable by traditional judicial means, but before these are put into action, the market reaction will be so vigorous and immediate that one could consider it to be the real sanction. Reference can be made here to the annual accounts restatements in the US, where violation of the accounting standards- often on revenue recognition -where at the bases of severe market corrections, culminating in the large scandals of World Com and Enron.

16. The market forces normally are driven by the information that is made available. The disclosure philosophy is the prevailing approach in securities regulation all over the world: by mandating relevant disclosures – e.g. annual accounts, price sensitive disclosures - it allows investors to continuously judge the value of their investment, and decide to buy or sell according to the information so obtained. By mandating certain information that results from standards, recommendations or other "soft" law instruments, the markets will be able to judge the quality of the disclosure and the value of its content, resulting in upward or downward price movement depending on whether the information was considered favourable or not. The price formation system in the securities markets can be considered as a refined and very sensitive continuous mass voting system for or against the firm and its management. It is highly sensitive but not always sensible, and even less predictable. Under the prevailing efficient market hypothesis, it is widely assumed that the prices in the market reflect all available information to all market participants. Therefore the market sanction is strongly related to the availability of information, leading to the idea that the markets are best policed by imposing disclosure of information relevant for the assessment by investors[25].

17. The most visible phenomenon is the effect of certain violations on the stock exchange prices: if a producer of soft drinks would be reported to have infringed the rules on the quality of the products mixed in its drinks, the stock price will immediately be affected, but the firm's long term reputation will suffer as well. Consumers may choose for other drinks, valuable personnel may fear for their future career and look for other jobs, while the firm's ratings will come under pressure, finally resulting in a deterioration of its borrowing conditions. Characteristic for this enforcement technique are the multiple facets that would be affected by a specific unfavourable fact and the interrelationship between these different facets. The unpredictability of the damage caused should be mentioned: in some cases, misselling of certain financial products to the public has endangered the survival of the bank, or the insurance company, all this notwithstanding other civil liabilities and criminal sanctions.

18. Attention should further be paid to the notion of the "market". In the first stage of analysis, this will be the market for the firm's securities, equities or bonds, which are extremely sensitive to unfavourable news. But the product markets should be included in the analysis as well. The securities market is ultimately made by buyers and sellers. The information on which these act is however influenced by numerous other parties: accountants, auditors, lawyers, investment bankers, public relations advisers, and so on. The asset managers acting for their clients and the financial advisers giving buy, hold or sell recommendations have a visible impact on price evolution. The financial analyst preparing elaborate reports will affect the share price. Rating

[25] "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectant electric light the most efficient policeman," in the word of Justice Louis Brandeis, Other People's Money and how bankers use, it, 1933.

agencies have a significant impact on investor's decisions: this is visible both in cases of ratings' downgrading, when investors are warned about the quality of their investment. It also creates an inflated picture if the ratings are maintained after negative evolutions have taken place, affecting the reputation of the ratings agencies as well. All this to indicate that the notion of "market" is a very complex one, with numerous interdependent factors and open to an undetermined number of outside forces, the individual effect of which is very difficult to determine.

19. If the markets react on sensitive negative information, one can assume that they will also be sensitive to all information that diverges from the standards of disclosure or behaviour that are considered applicable. On the one hand market participants will be satisfied when a company adheres to conduct that it considers desirable, or at least is considered acceptable in the interests of investors. But more generally, it will require rules, practices, codes of conduct etc. to conform to the perceived interest of the investors. Here one sees markets not only assessing conduct, but also influencing rule setting, linking ex ante and ex post.

20. "Investors" is an anonymous group of interests attempting to maximise its return on its investment. However, a further differentiation is needed. Small investors are essentially interested in return, most often long-term return and remain passive with respect to the conduct of the firm. If dissatisfied, they sell. But institutional investors who have much more market clout, will frequently not be able to sell and therefore have to engage in action to see their ideas accepted by the management and board of the company: these ideas will often refer to standards or codes as have been developed in the business community concerned. The best example to be mentioned here are the corporate governance codes: often these codes have been developed to respond to a request formulated by institutional investors, or by voting services. The codes are needed as a reference point for determining the position to be adopted by these investors or voting services in the general meeting. Derogations from the code, in fact derogations from widely accepted behaviour, will lead to protests and negative votes at the general meeting, or in some cases, to activism action by some shareholders. It is clear that these investors act, not so much to enforce codes or standards, but to pursue their own interest by advancing ideas that will be reflected in these codes. Some of their actions will also take place outside any form of standardisation and even against the codes, if these are deemed to weak or not sufficiently protective of these investors' interests. If the board proposes defences against a take-over, even if this is not contrary to the code, one can expect institutional investors to refuse, as the measure would exclude them from the benefit of a takeover.

21. The extreme sensitiveness of the financial markets can be compared with the somewhat lower sensitivity in the products markets, where defective products – often produced in contravention to technical specifications, corresponding to technical standards – have showed to be destructive of the consumers' confidence and the companies reputation. If defects are discovered, producers will whether recall the product or take them out of the markets altogether. It is well known that in many occurrences the market sanction is far more powerful, more immediate and much more difficult to control that the legal sanctions. Hence companies will try to develop standards and model specifications to be able to defend themselves in case doubts arise about the quality of their products. Some of these standards will be published and constitute self professed conduct rules, others will be subject to external scrutiny and strengthen the position of the firms in case something goes wrong[26].

[26] One could consider that this "self protection" is one of the functions of the "homologation" of technical specifications, e.g. for airplane parts: see the role of the European Aviation Safety Agency: http://www.easa.eu.int/home/index.html

4. The functions of standardisation in the financial services field

22. Standardisation serves numerous purposes. First and foremost standardisation serves the pursuit of economies of scale: many of today's mass services could not be offered if there were no standardised formats according to which these services can be calibrated. This phenomenon is very visible in the technical standards for instance for telecommunication, as used in the SWIFT messaging services. With the very high number of securities transactions being executed every day, the complexity of the transactions and the need for speed and reliability in the trading and post-trading phases, the entire transaction flow from the initial order up to the final settlement of the transaction has to be extremely streamlined and efficient. One does not see how this could be achieved without very fargoing standardisation, and the intensive use of electronic data transmission and processing[27]. In the absence of reliable and efficient transaction processing mechanisms in today's mass financial markets, a considerable risk would be created, that might degenerate into a systemic dimension. The initiatives that were deployed in the US for reorganising the clearing of derivatives a few years ago were clearly stemming form a systemic concern[28]. For supervisory purposes of tracing market manipulation in the integrated securities markets, a system of standardised reporting about securities transactions has been put into place, making use of standardised messages and sophisticated decoding and analysis methods[29].

23. Not only mass transactions, but also complex transactions can be efficiently structured thanks to a very high degree of standardisation. Standard contract forms as used in international commerce allow parties to enter into distance transactions without having to negotiate about each of the contract clauses. A mere reference – often not more than a couple of letters – will suffice to make the standard contract applicable. This not only allows to gain time and avoid lawyers' fees but more importantly avoid legal risks as most of these clauses have been used for a long time, commented on by the best writers, and litigated numerous times before highly specialised arbitrators. It is striking that in the field of cross border finance extensive use has been made of standard contracts, that have been developed by private associations, and correspond to a need of reliability and completeness that could only be achieved by standardisation[30].

See COMMISSION REGULATION (EC) No 736/2006, published in the Official Journal L 129/10 of 17 May 2006) regarding new working methods of the European Aviation Safety Agency for conducting standardisation inspections. This Regulation lays down the working methods for conducting standardisation inspections of Member States' national aviation authorities in the fields covered by Article 1(1) Regulation (EC) 1592/2002 of the European Parliament and of the Council of 15 July 2002 on common rules in the field of civil aviation and establishing a European Aviation Safety Agency (OJ L 240, 07/09/2002, p. 1), frequently amended.

27 It is interesting to notice that the volume of the transactions on the NYSE increased significantly after the physical delivery of securities was replaced by electronic processing: see: for the SEC rule change http://apps.nyse.com/commdata/pub19b4.nsf/docs/9FD194EF591789DF852570EC005E950F/$FILE/NYSE-2004-62app.pdf and http://apps.nyse.com/commdata/pub19b4.nsf/docs/99AE0ACE9AE0420F852571C7006095B9/$FILE/NYSE-2006-29app.pdf

28 BIS: New developments in clearing and settlement arrangements for OTC derivatives, 16 March 2007, http://www.bis.org/press/p070316.htm

29 The so-called TREM, whereby use will be made of ISIN codes. Comparable communication systems exist for VAT, for Police matters and for Customs coordination.

30 Reference to ISDA, International Swaps and Derivatives Association, Inc., that has published a 2002 ISDA, Master Agreement protocol http://www.isda.org/ . Originally these standard contracts were developed pursuant to a 1987 request from G 10 countries, and are still of importance to central bank operations, who contributes to their enforceability.

24. Standardisation is a strong integration factor: within the European context, imposing standard conditions, which these products have to meet, has enhanced the free flow of products. In the EU, a standardisation council is continuously dealing with a wide range of technical standards and specifications, which, as it is declared applicable in all states allows the products that conform to the standards to be sold everywhere in the community. International travellers know how difficult this exercise may be, confronted with electrical appliances that do not fit the electricity connections in another state. In the financial services field technical specifications in the payments area have proved crucial in making our payment systems interoperable, allowing competition among the different payment systems on the basis of a technically level playing field[31]. By increasing the competitive pressures overall costs and fees should normally be reduced. On the other end, the lack of standardisation often acts as a barrier against foreign entrants and hence reduces market integration, competition and effectiveness. In the field of securities settlement, a number of technical and political barriers have been identified, known as the Giovannini barriers, the existence of which have a negative impact on cross border securities settlement and are at the basis of the higher cost of cross border securities settlement in comparison to domestic settlement[32].

25. "Mutual recognition" is one of the key integration instruments in the European Union. It is part of the standard integration instruments in many European directives. In the future it is likely to play a decisive role in the US-EU financial market integration. However to accept products from other markets a minimum guarantee has to be produced as to quality of the financial product or service and as to the supervision exercised on it. Elaborate systems have been put in place to secure that objective. Standardisation for the characteristics of the product or of the supervisory process has played a role in this process in several ways. Product regulation is rather rare in the financial sector, but can be found in the directives on investment funds, and on consumer credit. The standard content of a public issue prospectus has been laid down in a detailed EU Regulation, standardising the information to be mandatory included in the prospectus. The communication as to whether the prospectus has been approved by a national authority and therefore whether the securities can be offered in another state, has been the subject of an agreement within the Committee of European Securities Regulators (CESR) whereby a common format has been accepted as the unique way of informing about the approval. This type of standardisation not only increases reliability of the communication, but also avoids host states to require additional documentation that could paralyse free cross border offering of the product. Without a certain form of standardisation, relating to the minimum guarantees for equivalence, the role of mutual recognition would be very limited.

26. Standardisation has always been rather strong in the accounting and auditing field. Auditors give their opinion according to highly standardised formats, allowing users of the accounts to rely on the nature of the review and the conformity of the accounts with the applicable rules. With the introduction of IFRS, the comparability of the accounts of companies belonging to different jurisdictions will increase. This will not only benefit investors who will have a larger choice of comparable investment decisions, it will make securities markets more competitive, but also stimulate and integrate securities markets and eventually increase the appetite of

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[31] See SEPA and European Payments council: http://www.europeanpaymentscouncil.eu/; see for an overview listing some of the standards to be used in SEPA, Bundesverband Deutscher Banken, Sepa 2008: Uniform Payment Instruments for Europe covering the whole range of payments within the EU: http://www.europeanpaymentscouncil.eu/documents/070702_SEPA_en.pdf

[32] In a proportion of 1 to 7 or according to some even 1 to 10: See the Second Giovannini Report http://ec.europa.eu/economy_finance/publications/giovannini/clearing_settlement_arrangements140403.pdf
see: K.Lannoo and Mattias Levin, The securities settlement industry in the EU: structure, costs and the Way forward, Ceps Research Report, 2001

companies to restructure by merging, or acquiring stakes in each other. One can expect that the higher comparability of accounting data under IFRS will strengthen the interest of investors and contribute to market integration.

27. To sum up, standardisation is indispensable in technical fields, especially in the mass markets, where it is needed to make the markets function in a smooth and reliable way, whereby systemic operational disruptions may be avoided. Standardisation further leads to a better protection of the investors by making the securities more easily accessible, and more comparable, creates a better level playing field, enhances competition. It allows mutual recognition to better come into play and thereby to stimulate integration of the different national markets. In some fields communication between supervisory bodies are governed by detailed standardised guidelines[33].

5. Standardisation and the law

The relationship between the different standardisation instruments and the law, to a large extent including the relationship between soft law instruments and the law, can be divided into two parts. The first one will analyse the formal aspect of that relationship, the second the substantive part.

a) The formal relationship with the legal system

28. The standardisation instruments as described above have a complex relationship with the formal legal system. Many of these instruments have a contractual nature, or derive their force from contractual relationship. Hence the relationship has to be described in contractual terms, including enforcement. However, the de facto force of some of these instruments is stronger than the contract terms: the party that does not follow certain ISO standards will be excluded from the market. The contractual relationship therefore serves essentially as the entry point to the multiparty network, and also as the basis for the affiliation to the service provider, but the real strength lies in the factual ability to be able to send messages worldwide, or to see one's contract terms accepted without discussion.

Also of a contractual nature are the cases in which a company would adopt, at board level, a local corporate governance code, declaring itself to be legally bound by the code's provisions. This decision would substantially change the legal nature of the self-regulatory code, and may, depending on national law, render directors liable for not implementing the substantive provisions of the code. Even more complicated would be the case in which a corporate governance code would be adopted by the general meeting of shareholders.

29. In some cases, the relationship with the legal system passes through a process of giving substance to "blank" norms, such as the rules on liability: when applying these provisions, the legal system, especially the case law, will refer to these standardised bodies of rules as these will be considered the applicable standard, or be designated the rule applicable to diligent behaviour of an average professional. This technique is used in a wide area of the law, both in general terms (general liability rules) or in specialised fields: director's liability may be measured on the basis of the corporate governance codes of conduct, liability of professionals such as banks on the basis of conduct of business codes that have been established by the bankers' association. Similar references are found in the law relating to e.g. product quality, or

[33] See supra note 29.

to subcontractors' duties, referring to the "normal use", or the "state of the art" in the execution of the work contracted for.

30. In more exceptional cases one could consider that the said standards, although based on a contractual embedding in the legal system en hence binding only on the contractual parties, will have a third party effect, without binding the latter unless he agrees. The liability of a bank against his client will be determined by taking into account e.g. the compliance with the technical aspects of the ISO code, if an error would have crept into the code system. More complicated examples could be devised in fields of data transmission. The third party effect of exoneration clauses can only be referred to here.

A conduct of business rules dealing with the relations of insurance agents with their clients may call for extensive information duties, both from and towards that client: on the basis of the intermediation directive, a self regulatory instrument – rather a model formulary to be used by the insurance agent - has been draw up by the association of Belgian insurance agents standardising the information to be requested by the agent from its client, especially when determining his "demands and needs"[34]. The effect of this voluntary instrument may be that a client may claim against his agent for not having adequately investigated his risk position. But the client – a third party in relation to the voluntary rules - will be expected to adapt his behaviour by disclosing all necessary facts needed to measure its risk. Otherwise the agent will rightly refuse to be held liable. Indirectly a self-regulatory instrument is imposing duties to third parties, as a consequence of the interrelationship of the obligations of both parties. It should be mentioned that said rules would come into play in the pre-contractual stage.

31. Not all instruments considered here have a contractual link with the parties: some are considered generally applicable, and not express reference is necessary to consider these obligatory. Corporate governance codes can be cited as examples: in some jurisdictions they have been made obligatory on the basis of an express reference in the law. However that link deserves further analysis as depending on the legal link the obligations will be different, both as to content and parties involved. In other cases, adherence to the code will be a condition for listing the securities on the exchange, and therefore also a condition for their maintenance as a listed security. But in several other jurisdictions, corporate governance "codes", or "recommendations" have been published with the statement that listed companies are expected to abide by them. There may also be recommendations from professional organisations, such an employer's associations. In the latter cases, the code draws its authority from the markets, being understood here in its widest sense.

b) The substantive relationship with the law

32. The use of standardisation bodies of rules or prescriptions allows parties to act without discussion of all the details of the agreement: this is particularly clear for the ICC model contracts for letter of credit. Also the body of law to which reference is thus made allows parties to better identify their legal position and hence their risks.

In several cases soft law instruments have been adopted to avoid regulatory intervention from the public authorities. To some extent that has been the case with voluntary corporate governance codes, especially those drawn up by employers' associations. It also was the case for the Code of Conduct on Clearing and Settlement, in the latter case as part of a deliberate

[34] See art. 12 (3) of directive 2002/6 of 9 December 2002 on insurance mediation.

policy of the Commission. In the political process this pre-emptive character will strongly depend on the willingness of all parties to abide by the rules so established. In corporate governance the poor result achieved in the field of disclosure of director's remuneration has urged some legislators to enact formal legal rules.

Standardised rules of conduct being most of the time self regulatory, these instruments have the advantage of adaptability but also of subsidiarity: by allowing the parties themselves to establish the rules to which they will be held, one can expect them to adhere to solutions that are best adapted to their needs. In that sense, "better regulation" is being served. However, there will always be a suspicion whether the draftsmen have only taken into account their own interest or those of the principals for which they have been working. By including a sufficient degree of general interest in the codes, a strong element of credibility will be achieved. This is sometimes also pursued by a strong appeal to ethical precepts, although the latter are often very vague. If – as was the case in most corporate governance codes- the public authorities have not been involved, the code's authority will be founded on its intrinsic merits, and will open to criticism once it appears that the actual implementation fails. This might then trigger government intervention.

32. In the Code on Clearing and Settlement, the European Commission, although not a party to the agreement, keeps a close eye on the follow up by the signatories of the code. This is done in an iterative process whereby the code's signatories are dialoguing with the other market participants (mainly the banks and the issuers' associations) to ensure acceptability on both sides. The Commission monitors the different steps, ensuring that these remain in line with the code, and with the Commission's political objectives, but leaving the technical works to the signatories themselves. One could consider this as an alternative form of cooperative rulemaking whereby all parties concerned are directly involved from the outset, but without using the strong arm of the law[35]. The level of detail and complexity of the subject, the multiplicity of the interests involved – and this on top of the relatively high number of signatories - but also the evolutive character of the subject matter explain why this approach has to be preferred to a formal one by directive, that would have triggered inextricable political strife. Efficiency reasons therefore also have played a significant role in preferring this rulemaking technique. The substance of this code has been determined by the Commission as the code essentially aims at achieving the policy objectives of the Commission. The legal status of the code is rather a political one, than a legally binding document. In case on non-implementation, a mediation procedure has been provided for, but arbitration has been definitely refused by the signatories. Sanctions would therefore be essentially reputation and political nature.

c) Enforcement

33. Enforcement is a crucial element in the use of the above-mentioned instruments. Legally enforcement will be a weak point with self-regulatory instruments, but there are other, sometimes stronger instruments that ensure the rules to be respected. The great diversity of enforcement tools requires a systematic presentation.

Technical standards are essential in the functioning of a system and therefore participants that refuse to adhere would be excluded in case of refusal. Obtaining access to the promised service passes by the use of the standardised conditions put forward by the service provider. Those who

[35] See for cooperative rulemaking within the EU.

refuse, or are technically unable to adhere to the system, will have to pay additional fees for having their orders adapted: payments executed without IBAN number will be whether refuse by the bank, or require a much more expense manual processing. The same would apply to some of these standardised contacts that are generally used in financial markets: applying other conditions will come with a cost, in time of sped of executions, redrafting formulas, and so on.

34. Purely voluntary standards or codes will per definition not call for legal sanctions per se, but may lead to disapproval in the markets affecting the firm's reputation, standing and even rating. This approach may not only apply to firms e.g. in the field of corporate governance codes, but to legal systems as well: officially published non compliance with the CPPS-IOSCO standards will have a negative impact on a state's reputation, and lead to pressure form the IMF to adapt. In addition, firms established in that state may also feel the pinch of the negative assessment.

Contractual standards and codes can be expected to lead to contractual sanctions. However these are often not very material taking into account h economic and financial environment in which the standard or code applies. Here one should further differentiate
Conduct rules imposed by an association – e.g. certain corporate governance codes, but also the conduct of business rules imposed by international associations of securities dealers – could be enforced by a "name and shame" procedure, but these are not necessarily very effective. Expulsion form the association could be an effective enforcement tool but rarely it will be a sufficient deterrent in se for avoiding refusal of the standard. Here again the market will be the main diver for compliance.

35. In some cases a link is established with access conditions: a few jurisdictions have established a link with the conditions for listing securities on the exchange. On initial listing the exchange will be expected to enforce its own conditions, although, taking into account the fierce competition for listing, a considerable flexibility can be expected. Once listed, violation of the standard will usually remain unenforceable: apart from reputation sanctions, or if fines can be effectively imposed[36], the possible removal of the securities from the price list results in the damage being inflicted on the investors, not on the unwilling firm. In the UK where the listing conditions are part of the regulation imposed by the Financial Services Authority, the latter could act more forcefully.

36. More and more, standards or codes are being issued under the proviso that they are not strictly binding, but offer a guideline that is expected to be followed unless the firm has good reason to believe hat the requirement is not adapted to its conditions and hence can derogate provided it explains the reasons got not following the code or standard. This approach is widely used in the corporate governance codes, and for good reasons: there are no universally accepted principles for good governance, and several approaches may be equally valuable. This is the "Comply and Explain" principle that was favourably considered and analysed by the European Corporate Governance Forum[37]. Enforcement in this approach is based on market assessment, including assessment by rating agencies or other specialised firms. However, assessment is also undertaken in comparative tables, drawn up by academics, official governance commissions, and even securities commissions. These generally do not aim at pointing to individual shortcomings, but at establishing the overall state of implementation, in order to conclude to

[36] Against which there might be objections as normally individuals cannot impose sanctions on each other. In several jurisdictions, penalty clauses are limited to damages inflicted.

[37] Statement of the European Corporate Governance Forum on the comply-or-explain principle, 22 February 2006. http://ec.europa.eu/internal_market/company/docs/ecgforum/ecgf-comply-explain_en.pdf

changes in the corporate governance code. In this respect they contribute to the political debate, pointing at manifest shortcomings in the implementation of the codes.

37. Legal sanctions, such as liabilities, are generally not directly attached to the violations of standards or codes. Often these instruments have been developed to keep the subject matters outside of the legal realm. In fact however, the law will sometimes capture some of the elements of these instruments and without attaching legal consequences to the code or standards itself, incorporate the substance in its decision-making. This phenomenon can be expected to happen in terms of liability, contract interpretation or performance, and other fields where the legal system leaves core concepts to the interpretation of the judge.

38. Apart from legal or reputation sanctions, many of the subjects dealt with here have a strong political content: success of codes or standards raises political attention, and even distrust. Some codes are enacted to avoid the legislator to adopt more stringent regulation, and there are several examples illustrating this fall back option[38]. This also means that these voluntary instruments only can continue to exist to the extent that they deliver effective and credible results. The same tension between public policy and private law approach can be identified in the Code of Conduct on Clearing and Settlement, where a mix between public and private law has been realised deliver something that is essentially a general good. In all these case one could say that the private solution lives by the grace of public policy.

39. To what extent can soft law instrument, including self regulation can be used to implement European directives? In certain fields, it has been admitted that directives can be implemented by other instruments than national law or regulation, e.g. in labour law where collective agreements have been considered sufficiently stable to allow them as instruments for realising European policy. In the field of financial regulation, no examples of he like are known. This may be due to he fact that these directives often affect a wide range of interests and that therefore enforceability through the courts if usually necessary.

Against the use of soft law or self regulatory instrument for the implementation of the directives in the fields of financial regulation, objections have been raised especially as to their precise character, their effect being limited to the contracting parties, and finally the absence of formal enforcement instruments, both for the contracting parties, but more importantly for third parties that may affected by these rules. Competition concerns have also been voiced.

Conclusion

The subject of standardisation, self-regulation and soft law in financial services lend itself to a very wide range of analyses. The use of this type of instruments is particularly developed in the financial field, as the markets play a very important role, and the conduct of market participants is continuously assessed and decided upon. However, the law always lurks behind the corner, directly or indirectly. This reveals the fundamental tension between public and private law. Efficiency considerations are paramount and are reflected in the concerns about enforcement. Unless the organisation supporting the soft instrument can guarantee that it will be fully implemented and enforced, and that third parties can require enforcement, the European legal

[38] See the German voluntary codes on Insider Trading and on Takeover Bids, the failure of which has lead the government to enact legislation. Similarly with the Swiss takeover board A similar development could be witnessed with respect to the disclosure of remunerations of directors (e.g. the French law: Code de commerce: L 225-102-1). See the European recommendation 2004/913 of 14 December 2004 fostering n appropriate regime for the remuneration of directors of listed companies, OJ L. 385, of 29 December 2004, 55.

order would seem to object against the use of soft law instruments. Therefore additional research should be undertaken to determine whether this gap can be filled. In the meantime we will continue to be confronted with the avalanche of regulation.

Financial Law Institute

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