Marine Ayvazyan 991153688

International Financial and Fiscal Law Review

Question 1.
Explain how securities regulators respond to internationalization of capital markets. What problems does internationalization pose? What are the best responses and why?

Capital markets of each country are developed to promote financial services within that country. Internationalization of capital markets, means allowing foreign companies securities to trade abroad. It encourages increase of foreign ownership and control of shareholdings. It encourages flow of capital from one country to another. At the same time the differences in regulations of capital markets in relation to securities may lead to the local security traders' feeling of "being not protected" under the invasion of foreign brokers. There is a need in securities law-protection. In the US there is a theory of securities' regulation, which includes the information about disclosure requirements, asymmetry of information, information on profitability and information about investors-supply and demand and equilibrium of price.

Securities market is the allocator of capitals, so the purpose of security's regulation is to protect this social mechanism. Internationalization of capital markets means that the regulators need to protect not only the local society by means of protecting of local investors, through provision of fair, material information about the risks of securities, but also examining foreign contexts. Very often, protecting the market means to ensure confidence in market, there is a necessity to have law which regulates local and international context of these transactions. The reason for securities regulation is identification of systemic risks, providing information on capital allocation, etc, which is usually included in the prospectuses.

One of the problems that this internationalization may pose is the additional volume of due diligence that specific country regulators should perform to properly reflect all of the investors concerns. This will require additional resources and time. The information about foreign investors may be nor reliable and trustworthy, which will cause additional risk. Regulators will need to examine financial papers (the balance sheet or the income statement, management's discussion of results and operations, material contracts, information about other shareholders, capital structure, etc. In addition to that US law, for example, requires to segment information by geographic segments as well as by business line segments. All of those peculiarities need to be thoroughly examined and reflected in the regulatory documents.

The same problem refers to issuers. The process goes in the following way. Issuer hires the underwriter then the underwriter writes the prospectus and does the due diligence. The information about the structure of underwriting in the foreign country need to be examined, amount of commission defined. Additional due diligence may cost money for issuer- hence they may be opposed to internationalization. At the same time for underwriters it may serve as a source for additional income. It should be mentioned here that issuers have greater incentive to lie, while underwriter have lower incentive to lie, so the risk of fraud should be addressed as well, which is more often done by auditors.

In general, global offering of securities means that the company should comply with securities' laws of other countries. There may be difference in legal system structures, such as civil law versus common law, level of protection for investors and markets; different market structure (more or less liquid) which should be taken into consideration. The respective governments should work together towards collaboration to enforce the law, inked to harmonization of rules. The responses to different legislations and regulations are the following. EU issued special directives to harmonize legislations: mutual agreements between countries have been signed to adopt enforcement cooperation. In some cases national treatment is applied, which means they threat foreigners equally, if they accept local stricter regulation. There is a rule of accepting foreigners and recognition of their local regulations. Of course, this does not necessarily means that the sphere are completely regulated and harmonized. There are still differences for different countries-e.g. Germany and Mongolia, which need to be resolved on a case by case basis. Still Japan, Korea and US are difficult markets to enter, mostly because of fraud concerns and prudential regulation purposes.

Besides, in practice unilateral arrangements are done to provide preferential treatment or recognition, meaning that in different cases different treatments may apply. European Union fosters mutual recognition, which means creation of EU single market, based on essential harmonization (EH). In its core it harmonizes legislations through political negotiations. The example of Margaret Thatcher, who favored mutual recognition, thus expecting to have decreased regulation costs, is an example of application of harmonization in practice. Adversely, US were reluctant to accept any mutual recognition given their belief that their regulation system was the best one. Though in recent years the situation has changed and US became more flexible, thus it agreed to change its financial standards to meet international standards, also currently EU firms will be able to offer securities in the US, currently they are being recognized but yet not legislated. For the US firms internationalization also means expanding the domestic investor opportunities US investors wanted to invest in foreign securities, they will do it one way or another, however, if they do it abroad they will got comparatively less protection.

Question 2. How does moral hazard arise in corporate law, in bank lending, and in bank regulation? What are the different ways in which moral hazard is addressed, and what are the limitations on the ability of governments to address moral hazard?

The moral hazard in general comes as a result of information asymmetry provided by both counterparts in transaction. As a result of hidden or fraudulent information the one party makes decisions that does not correspond to the real level of risk and thus, making the legal obligations of the counterpart almost unachievable. This situation creates a moral hazard, in which the initial party will try to cover the previous risk by tightening the legal conditions, which, in turn will almost eliminate the possibility of identification of the truly eligible partner to meet the set criteria to be valid for the particular legal agreement. Moral hazard arise differently in corporate law, bank lending and in bank regulation.

There are five main characteristics of the corporate law: 1) legal personality, 2) limited liability; 3) transferrable shares; 4) delegated management through the board and 5) investor ownership Most corporations are incorporated under these five principles, though some may drop one or two. As firm represents the interconnection (nexus) of contracts or legal obligations with

shareholders and stakeholders, which most often may have different preferences. To what extent can corporate law solve these problems? What are other social mechanisms that operate to ensure these problems don't arise? There is a social norm of responsibility to directors, officers outside of the legal system. Law says that managers have a fiduciary duty to maximize shareholder value. How does this legal mechanism work – how congruent do interests become?
There are 3 kinds of conflicts of interests: a) between manager and shareholder; b) among shareholders (ex. between minority and majority shareholder); and c) between shareholders and other constituencies – i.e. creditors, suppliers etc. From the U.S. law standpoint corporate law only protects shareholders and not creditors. The moral hazard arises when managers' incentives are not sufficiently congruent with those of the principal.

In corporate law securities market regulation also incorporates moral hazard, when the brokers-security traders try not to properly disclose all the risks associated with the security, thus forcing investors to make uniformed decisions. This is an information asymmetry, which leads to moral hazard and leaded to the break of the system.

The moral hazard in bank lending mostly came from subprime loans. The new products – derivatives were very complex, and the system in which they are created is also complex. Not all of the players can and willing to present proper information when entering transaction. Thus, borrower hides the information about real income, thus, forcing credit rating agencies (which are interested to overstate the assets) to give high rankings to borrowers. Lenders (banks) tend to believe the CRA and making the risky loans to those, who are unable to meet their legal obligations. The information asymmetry arises, which leads to moral hazard.

The goals of regulators in the banking field is to reduce the moral hazard by imposing more requirements for information disclosure. However, in reality we experience bail-outs of lending institutions by governments, central banks or other institutions. This all encourages risky lending in the future. Having the government support, banks and lending institutions may go into riskier transactions, thus, making the risk of moral hazard even more.

Hence, there was a list of recommendations provided from group 30 regarding strengthening regulatory requirements, including information disclosure requirements in all of the financial fields, such as, banking filed, securities, etc. To address this type of moral hazard for the banking field for the government is to do strict monitoring as well. All of these recommendations are closely related to the financial implications, which are connected with limited resources. Also there are political challenges as well that needs to be addressed during designing any new policy.