

NETWORKS, POLITICS AND MARKETS:
THE INTERNATIONAL DIFFUSION OF INSIDER TRADING RULES

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I. Introduction

A critical differentiator of national business systems is the organization of financial markets. Two decades ago, scholars had identified market-led, state-led, and negotiated adjustment as three distinct industrial development strategies rooted in different systems of corporate finance (Zysman 1983). Since then, observers have noted a marked shift towards the market model of finance, particularly in the OECD, but also beyond (Cohen 1996; Kitschelt et al. 1999). The greater emphasis on capital markets has been associated with an increasing reliance on regulatory tools developed in the United States, the global reference point for market-based finance. Whereas few countries in the early 1980s had independent regulatory agencies to monitor securities markets, this “SEC model” has since become near hegemonic in the OECD (Laurence 1999). This of course does not mean that countries around the world have merely copied U.S. regulation or that there has been full convergence. As previous work has shown, financial market reform usually entails complex re-regulation to combine elements from the new paradigm with existing structures in path-dependent fashion (Moran 1994; Vogel 1996). Still, the relative convergence toward market-based finance has transformed governance priorities, elevating principles of transparency and investor protection.

A particularly stark point in this transformation is the global spread over the last twenty-five years of rules banning insider trading. In 1980, the U.S. was one of only 11 countries among the 60 countries with stock exchanges that formally prohibited insider trading. The UK, Japan, Hong Kong, Germany, and Switzerland are just some of the global financial centers that lacked such rules at the time. By 2000, the situation had changed dramatically: an astonishing 90 of now 110 countries with stock exchanges had moved to ban insider trading and the practice was illegal in all major financial markets (Bhattacharya and Daouk 2002). What explains this

diffusion of insider trading policies across the globe? And, once adopted, what explains different cross-national patterns of enforcement of these laws?

Research on policy diffusion generally explains such outcomes with reference to a set of external drivers that interact with domestic attributes. Arguments focused on internal conditions often include variables stressing functional pressures (e.g. countries develop welfare states when they have reached a certain level of modernization) or internal political variables (e.g. democratization promotes the adoption of accountability policies). Arguments based on external factors, by contrast, posit that policy developments are substantially affected by actions in other jurisdictions. Previous studies have identified a range of causal mechanisms, including coercion, economic competition, learning, emulation, and persuasion (Simmons, Dobbin, and Garrett 2006b). In this study, we are particularly interested in the role that policy networks might play in policy persuasion. Over the past two decades, securities regulators from around the world have created a dense network of cooperation, centered on cross-border fraud prevention and regulatory harmonization. While considerable empirical work has already examined the role that market pressure and mimetic copying play in diffusion processes, the importance of such “transgovernmental regulatory networks” has so far been neglected. In order to shed light on patterns of adoption and enforcement of insider trading regulation around the world, we have constructed a database of 114 countries stretching from 1977 to 2004. We scrutinize both internal and external factors and pay special attention to the role that transgovernmental cooperation may have played as a driver of policy diffusion.

The study contributes to two exciting new areas of study in the field of international political economy. The first is a growing body of literature that investigates the causal factors and mechanisms associated with the international diffusion of certain policies. Building on neoinstitutional work in sociology (DiMaggio and Powell 1991), authors have begun to

empirically study the role of emulation, coercion, and normative pressures in the international diffusion of policies such as capital account liberalization (Simmons and Elkins 2004), central bank independence (Polillo and Guillen 2005), or industry liberalization (Henisz, Zelner, and Guillén 2005). The topic of policy diffusion in general is attracting scholars from a broad range of backgrounds, spanning political science, sociology, management, and law. A special issue of *International Organization* is forthcoming specifically on the topic of the global diffusion of liberalism (Simmons, Dobbin, and Garrett 2006a). While the international diffusion literature has focused holistically on the spread of policy innovation, this study goes one step further by consciously differentiating between mechanisms that foster policy adoption and those that promote policy enforcement.

The second literature to which this study contributes focuses on the rise of transnational networks among domestic regulatory agencies. Spearheaded by international legal scholars, this literature posits that domestic regulators increasingly work with their foreign counterparts to jointly confront regulatory challenges posed by a globalizing world economy (Newman forthcoming 2008; Slaughter 1997; Slaughter 2004). The resulting transgovernmental regulatory networks are noteworthy because they constitute international cooperation that is not under the direct control or influence of heads of government or foreign ministries. Empirical studies have focused on the rise and institutionalization of network-based cooperation among central bankers, securities regulators, and insurance commissions (Raustiala 2002; Slaughter 2000; Zaring 1998), as well as among competition policy authorities (Fox 2000; Smitherman III 2004).

While empirical studies of transgovernmental regulatory networks have gone a long way toward identifying both proximate and underlying causes for cooperation, there is so far no systematic assessment of whether – and, if so, how – regulatory networks actually matter for policy. Conversely, while some empirical studies of international policy diffusion have

considered the role of international organizations such as the IMF or WTO, none has specifically investigated the causal importance of direct transgovernmental cooperation among regulatory agencies. This study therefore contributes to both literatures while at the same time building a bridge between them. Moreover, it adds to the growing body of work on governance in a globalizing world economy (Drezner 2001; Held and McGrew 2002; Hirst and Thompson 1999; Kahler and Lake 2003; Prakash and Hart 1999; Vogel and Kagan 2002). International financial markets are among the most integrated, with more than one \$1 trillion crisscrossing the globe on any given day. Yet financial market regulation remains very much in the hands of national governments. The dynamics of policy diffusion in this area therefore warrant careful attention. Particularly as proponents of transgovernmental networks tout them as robust building blocks for global governance in an era of globalization, empirical scrutiny about their effects is called for.

The remainder of the paper proceeds as follows. We begin with a brief discussion of insider trading and present data on the worldwide spread of rules banning the practice over the past three decades. Based on an analysis of existing literature, section III identifies various internal and external drivers of policy diffusion that could contribute to an explanation of the empirical pattern. To this set we add the role of persuasion through transgovernmental regulatory cooperation, which we consider in detail in section IV. The transgovernmental campaign against insider trading – driven initially by the SEC – has been of critical importance both for the onset and the subsequent institutionalization of regulatory cooperation in the industry. We present preliminary results of our empirical analysis in section V. The final section concludes with areas for future research and implications for both theory and practice.

II. The Worldwide Spread and Enforcement of Insider Trading Regulation

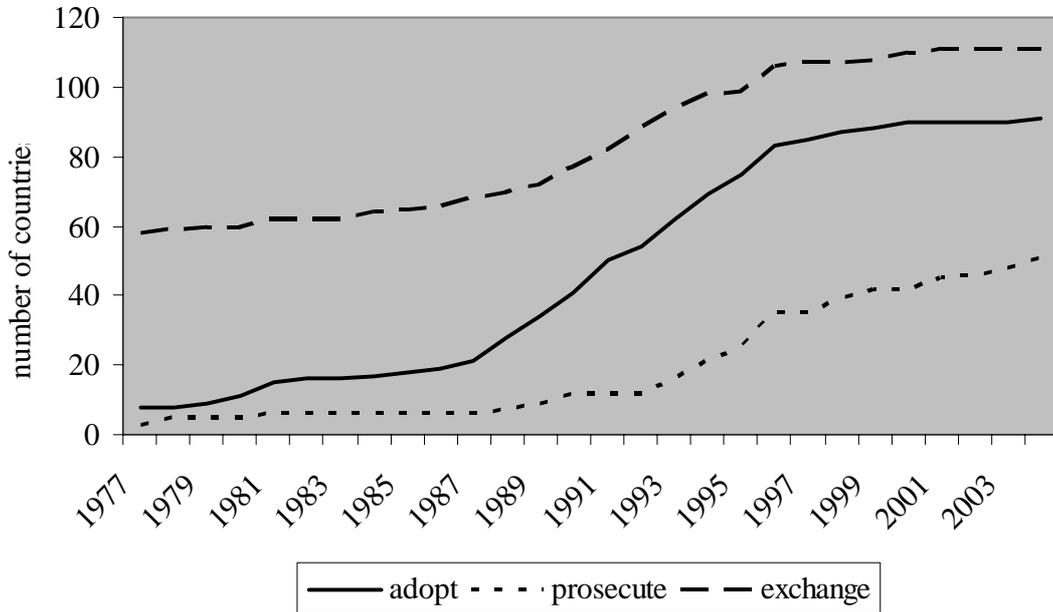
The modern crusade against insider trading has its origins in sweeping reforms of U.S. securities law enacted as part of the New Deal. Reestablishing confidence in securities markets among small investors in particular following the 1929 stock market crash required an entirely new regulatory paradigm. New legislation declared transparency, fairness, and investor protection principal goals of U.S. securities regulation and created the Securities and Exchange Commission (SEC) as a powerful and independent market watchdog. Insider trading – which the SEC defines as “buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security”¹ – cannot be tolerated in a system meant to promote transparency, fairness, and the protection of investors. With the passage of the Securities and Exchange Act in 1934, the U.S. therefore became the first country to formally define and ban the practice of insider trading. However, it was not until the 1960s, after Congress had given the SEC additional investigative and enforcement powers, that regulators launched an aggressive campaign to stamp out insider trading in U.S. markets. The issue has not been without controversy (Bainbridge 1999). At the time, some commentators argued that insider trading should be seen as a compensation tool for managers and an efficient way to incorporate information into the share price (Manne 1966a; Manne 1966b). More recently, critics have stressed that insider trading involves an exchange between the insider and the issuer, a purely private relationship that should not be regulated by the government (Carlton and Fischel 1983; Haddock and Macey 1986). But these voices have been in the minority. The accepted wisdom among U.S. scholars and practitioners – in the fields of finance as well as law – has been for some time that insider trading is fundamentally incompatible with fair and transparent securities markets and that regulators must continuously monitor market activity and vigorously pursue potential offenders to dissuade any form of insider

¹ See the SEC’s website at <http://www.sec.gov/answers/insider.htm>.

trading (Loss and Seligman 1991). Moreover, as recent studies have shown, the toleration of insider trading in a market is closely associated with higher cost of equity for companies, as foreign investors in particular shy away or demand risk premiums (Bhattacharya and Daouk 2002; La Porta, Lopez-de-Silanes, and Shleifer 2006).

Despite the many good political, legal, and economic arguments against insider trading, the U.S. long remained a lone voice, joined only in the late 1960s and 1970s by a handful of other countries willing to formally ban the practice. As recently as the 1980s, the vast majority of countries with stock exchanges did not ban insider trading by law. Since the 1980s, however, the situation has changed dramatically. As Figure 1 shows, the number of countries banning insider trading has increased exponentially, growing from a mere 8 in 1977 to 91 by 2004. The 1990s in particular saw widespread adoption of insider trading rules around the world. The simultaneous growth in the number of stock exchanges has certainly been a contributing factor. But as the figure shows, the number of countries banning insider trading has risen much more quickly than the number of countries with stock exchanges. Expressed as a percentage, insider trading was formally banned in 14 percent of countries with stock exchanges in 1977, compared with 82 percent by 2004.

Figure 1: worldwide spread of insider trading regulation, 1977-2004



While powerfully illustrating the worldwide spread of insider trading regulation over the past three decades, Figure 1 also shows that only a fraction of countries has actually prosecuted cases of suspected insider trading. By 2004, only 56 percent of countries banning insider trading had actually prosecuted a case. One interpretation of this statistic is that a large number of countries have simply failed to enforce the new regulation. Cynics might argue that many countries have merely paid lip service – perhaps in the hope of attracting foreign investors – and have failed to put their money where their mouth is.

Yet the picture is more complicated. A prosecution requires first, that there is an actual instance of insider trading, secondly, its detection, and thirdly, the willingness and ability of the regulator to gather sufficient evidence to formally bring charges. Only the third part of the equation focuses on actual compliance with an international commitment, as the concept is conventionally used in the literature (Chayes and Chayes 1993). The first part establishes a baseline probability of prosecution in a given country and instances of insider trading may or

may not be normally distributed across countries or even trading volumes. Particularly interesting is therefore the second piece of the equation, the issue of detection. While powerful statistical algorithms help leading international regulators such as the SEC detect abnormal trading patterns, the actual detection of a case of suspected insider trading is anything but routine in most countries. A combination of high technical skill on behalf of the market supervisor, accurate data, and sophisticated technology is necessary to discover insider trading.

Rather than simply ascribing the relatively low share of countries that have actually prosecuted a case universally to a failure to enforce, this study treats this statistic as an additional piece of the empirical puzzle. Do the same causal factors drive the adoption of rules and the prosecution of cases across countries and time? Does international regulatory cooperation, if it matters at all, have a greater influence on the probability of adoption or the probability of prosecution? Before considering these questions, let us first turn to variables other than regulatory cooperation that might affect a country's decision to come down on insider trading in its securities markets.

III. Drivers of Domestic Regulatory Change

There is now a robust theoretical literature on the drivers of policy diffusion and innovation under conditions of international interdependence. Building upon foundational studies of institutional isomorphism (DiMaggio and Powell 1991), scholars have developed consistent mechanisms that yield testable propositions. While the actual operationalization varies across studies, most studies of diffusion phenomena distinguish in one way or another among competition, coercion, (deliberate) learning, and (less conscious) emulation as distinct drivers (Simmons, Dobbin, and Garrett 2006b). To this we add the role of persuasion, which we model as a driver of diffusion that is theoretically and empirically distinct from both learning and

emulation as currently employed in the literature. Before considering these various international drivers, we begin with a consideration of domestic-level variables given that domestic factors may well affect a jurisdiction's responsiveness to international pressures (Garrett and Lange 1996).

Domestic Drivers

Economists in particular might simply view the decision to formally ban insider trading as the natural result of market evolution. The fact that modern insider trading regulation was born in the United States – host of one of the oldest, most liquid, and undoubtedly most important securities markets in the world – lends intuitive support to this argument. Similarly, such a modernization argument would predict enforcement efforts to intensify with a market's growing size and importance. More financial transactions raise the likelihood that abuse might occur and, as markets mature, regulators should become better skilled at discovering such abuse. In either case, the expectation is that a market's position on its evolutionary trajectory should be related to its regulation, *de jure* and *de facto*, regardless of international pressures or developments.

Besides a securities market's maturity, there are a number of other domestic variables that could affect a country's propensity to ban insider trading. Studies of the diffusion of market liberalization, for example, have examined the relationship between political freedoms and economic regulations. Insider trading regulation protects ordinary investors against abuse by corporate insiders. The more a society cherishes and protects individual rights the more likely it should be to have formally banned insider trading.

A related concept is a country's legal tradition. Modern insider trading regulation has its roots in U.S. regulatory philosophy and in many countries civil litigation is a cornerstone of securities law enforcement. Common law countries might therefore have a higher likelihood to

ban insider trading than civil law countries in which a greater precision of rules and more centralized enforcement is necessary.

Similarly, countries that are committed to strong and independent regulation of their financial systems – as indicated, for instance, by the presence of an independent central bank – could be considered more likely to enact rules banning insider trading and to subsequently enforce them.

Coercion

Apart from purely domestic drivers stand a set of diffusion mechanisms that ascribe the worldwide spread of certain policies at least in part to international political processes under conditions of interdependence. For instance, external pressure from powerful international actors has frequently been singled out as an important driver of domestic policy change (Meyer et al. 1997). Such pressure can have a direct or an indirect effect. As Henisz, Zelner, and Guillén (2005) explain, “[i]nternational coercion occurs when powerful actors influence the policy choices of governments directly, or when such actors alter the outcome of a domestic political struggle by favoring the domestic coalition supporting a given policy.” While such agents can in principle include non-governmental organizations, they tend to be either powerful states or international organizations reflecting the preferences of powerful states (Simmons, Dobbin, and Garrett 2006b). The conditions attached to IMF loans are a clear case of coercive pressures exerted by an international organization. In recent years, such conditions have included demands for the liberalization and privatization of key industries and Henisz, Zelner, and Guillén (2005) indeed find that countries who receive IMF or World Bank loans are significantly more likely to open up their telecommunications and electricity markets.

The IMF has not used loan conditions to force the ban of insider trading the same way it has attached demands for industry or capital account liberalization to bail-outs. But this does not mean coercion is absent in the field of insider trading. Two particular mechanisms can be identified, one featuring the U.S. and the other the European Union. The U.S. has not deliberately imposed sanctions on a country to force changes in its securities market regulation.² But foreign firms listing on U.S. exchanges have to comply with U.S. law, including U.S. insider trading regulation. David Vogel has shown how strict regulatory standards in attractive markets can force a “ratcheting-up” of regulation elsewhere (Vogel 1995). Foreign firms already complying with strict U.S. rules might not oppose tightening of regulation in their home markets. In fact, they might actively promote regulatory tightening at home to reduce transactions costs resulting from dissimilar standards and to impose adjustment costs on domestic competitors. Countries that have firms listing on U.S. exchanges should therefore be more likely to adopt U.S.-style securities regulation – including a ban of insider trading – than those that do not.

A second potential causal pathway stressing international coercion involves the EU. In 1989, the European Community adopted the Insider Dealing Directive (IDD), requiring member states to ban the practice where it was still not formally illegal. Through the directive, the prohibition against insider trading became part of the *acquis communautaire*, the body of EU legislation candidate countries have to adopt in order to qualify for membership. It is therefore likely to have played a role especially among Eastern European countries and other recent EU members.

Competition

² In this respect, securities regulations differs markedly from intellectual property regulation, for example, where the U.S. threatened and imposed bilateral trade sanctions to force foreign governments to boost protection of patents and copyrights. See Matthews 2002 and Sell 2003.

International competition for scarce resources is a prominent factor that has been invoked to explain countries' decision to adopt certain policies. *A priori*, this argument seems particularly compelling for the case of securities market regulation. In an increasingly competitive and ever-more integrated global economy, attracting foreign investment has become a critical objective of domestic economic policy, not just in developing countries. Since the quality of financial market regulation and particularly the extent of investor protection has been shown to be related to investment decisions (La Porta, Lopez-de-Silanes, and Shleifer 2006), we can hypothesize that countries are altering their policies in response to changing dynamics in the global market for capital. Adopting and enforcing insider trading laws sends an important signal to potential investors (Bhattacharya and Daouk 2002). As competitors for the same investment capital move to ban insider trading and therefore offer foreign investors greater protection, follower states may feel compelled to follow suit (Simmons and Elkins 2004).

Learning

Learning involves a change in beliefs, usually in response to new information (Levy 1994). In the policy diffusion literature, learning is generally viewed as a conscious activity in which a country evaluates available policy options and chooses on the basis of rational self-interest (Simmons, Dobbin, and Garrett 2006b). Most common in this respect is "learning from success." Simmons and Elkins capture this effect by looking at the policies of the fastest growing countries (Simmons and Elkins 2004). The greater the share among those that have adopted a particular policy, the stronger the signal that this policy "works" and the greater, therefore, the incentive for others to follow suit.

Emulation

Emulation and learning are not the same. Whereas learning, as employed in the policy diffusion literature, rests on a logic of consequences, emulation “involves less rational and more subjective imitation processes based on a less rationally based logic of appropriateness” (March and Olsen 1998; Simmons, Dobbin, and Garrett 2006b). Indeed, many studies have demonstrated the importance of emulation in institutional isomorphism in general and the process of international policy diffusion in particular (Benavot et al. 1991; DiMaggio and Powell 1991; Henisz, Zelner, and Guillén 2005; Simmons and Elkins 2004; Strang and Meyer 1993). Countries copy policies from one another, particularly in times of uncertainty and especially if a common bond exists between them. Possible reference groups for policy emulation include neighbors and countries that have religious, lingual, or colonial ties. But countries may also follow a more general “trend of time,” adopting policies that are increasingly commonplace in the international community.

Persuasion

Whereas emulation is the simple copying of policies from other countries, persuasion involves complex two-way interactions that lead a follower to consciously adjust its behavior in response to a mix of normative and coercive pressures. Persuasion can emanate from a single leader, an expert community holding special knowledge, or a growing consensus among a group of like-minded actors. In either case, for persuasion to occur, the follower needs to be somehow linked to the actor or group of actors doing the persuasion. We posit that transgovernmental networks act as critical conduits of persuasion among countries. Recent research on gender mainstreaming, for example, has shown that cross-national networks of feminist NGOs have played a critical role in the spread of gender mainstreaming agencies across countries (True and Mintrom 2001). Previous work on epistemic communities has highlighted the important role of

international experts in shaping international policy agendas and promoting adoption through teaching and lobbying (Haas 1992).

There are multiple ways through which the transgovernmental network linking many of the world's securities regulators could be expected to have contributed to the spread of insider trading regulation and its subsequent enforcement. As the following section shows, market distortions caused by insider trading have been at the heart of regulatory cooperation in the securities industry since its infancy in the early 1980s. The SEC in particular has relied on the expanding network to promote its vision of securities regulation, culminating in the adoption of a set of benchmarks and principles in 1998 that stressed the incompatibility of insider trading with modern securities markets. Through the network, the SEC and like-minded regulators thus set the international policy agenda in the securities industry, defining normative standards affecting others. Externally legitimized policy options have been shown to often tip domestic policy debates in a certain direction (Henisz, Zelner, and Guillén 2005; Meyer and Rowan 1991). Moreover, participation in the network fosters information exchange and capacity building, particularly because training has been a cornerstone of institutionalized cooperation (Raustiala 2002). For these reasons, network participants should therefore be more likely to adopt policies promoted by leaders within the network than those who do not actively participate in the network.

Regulators rarely get to write a country's securities laws, however, and persuasion through transgovernmental cooperation is therefore likely to have limits. All else being equal, regulators plugged into an international expert network are likely to have more influence in domestic regulatory debates than those who are internationally isolated. But the decision to ban insider trading is generally taken by governments and enacted through legislatures, neither of which actively participate in the transgovernmental securities network. Indeed, it is possible that

regulators begin to engage in cooperation with their foreign counterparts once the decision to reform securities regulation has been taken. In this case, network-based transgovernmental cooperation might just be epiphenomenal to domestic political processes, mirroring the argument realists have made for international institutions in general (Mearsheimer 1994). Yet once domestic laws have been changed, the task of implementing and enforcing the new rules falls to regulators. In this regulators can benefit tremendously from information exchange, best practice diffusion, and training facilitated by the network. Regardless of its effects on the adoption of insider trading rules, transgovernmental cooperation through a regulatory network should therefore increase the probability that a newly enacted ban of insider trading is actually enforced.

While coercion, competition, learning, and emulation are well established in the literature as mechanisms of policy diffusion, the notion that persuasion through transgovernmental regulatory cooperation could have played an independent causal role is somewhat novel. To establish a basis for the argument, the following section therefore briefly assesses the origins and subsequent institutionalization of regulatory cooperation in the industry. We show that the problem of divergent insider trading regulation in globally integrating markets was the proximate cause for cooperation, and even though cooperation has ventured into many other areas of securities regulation, the quest against insider trading remains a central focus.

IV. Insider Trading and International Regulatory Cooperation

Contemporary global governance in the securities industry is characterized by a high degree of regulatory cooperation. Over the past twenty-five years, the world's securities regulators have created a dense transgovernmental network. It has two principal building blocks: a large number of bilateral Memoranda of Understanding (MoU) and the International Organization of Securities Commissions (IOSCO), which acts as the network's de-facto

secretariat. MoUs establish specific procedures for information sharing and enforcement cooperation among pairs of regulatory agencies in an effort to enhance cross-border law enforcement and fraud prevention. Through IOSCO, which is formally a private body, regulators from more than one hundred jurisdictions harmonize standards, develop best practices, and diffuse knowledge through training and peer advising.

The Origins of Cooperation

Regulatory cooperation in the industry was a direct consequence of the SEC's initial inability to properly pursue two cases of likely insider trading. In March 1981, an unusually large purchase order for call options and common stock for St. Joe Minerals Corp. was placed in U.S. securities markets. The next day, Joseph E. Seagrams & Sons announced its intention to acquire all outstanding shares of St. Joe for \$45 per share, a \$14 premium. Whoever had placed the order the previous day had made a thirty percent profit overnight. For the SEC it was a clear case of illegal insider trading (Mann, Mari, and Lavdas 1995). The SEC's enforcement division therefore asked the bank that had placed the order to produce information about the transaction's originator. However, the order had been placed from Switzerland and the originating bank, the Banca Della Svizzera Italiana, cited Swiss banking secrecy law and refused to cooperate. While this was not the first time SEC efforts had been thwarted by foreign non-cooperation, the extent of the damage in St. Joe was unprecedented. At about \$2 million, it was at the time "the SEC's largest insider trading case ever," foreign or domestic (Smith 1988).³

A few months later, there was a second, even larger case of suspected insider trading involving Swiss banks. In October 1981, the Kuwaiti government announced its plan to purchase

³ The biggest domestic insider trading case that year comprised illegal profits of only about \$450,000. See SEC 1982.

Santa Fe International Corp. for more than twice the company's share price. And just as in the case of St. Joe, the official announcement was preceded by an unusual volume of options purchases for Santa Fe by several of the largest Swiss banks. Thousands of call options that would expire within a few weeks and had been purchased for a few cents apiece were now worth between \$5 and \$15 a share. The damage was even greater than in St. Joe, about \$8 million (Smith 1988).

Since insider trading was not illegal in Switzerland, the SEC could not invoke an existing Mutual Legal Assistance Treaty (MLAT) between the two countries. Such treaties can only be invoked in cases of "dual criminality", i.e. where an action is a criminal offense in both jurisdictions. To nevertheless compel the release of information about the transactions' originators, the SEC – in both cases – sued U.S. subsidiaries of the originating Swiss banks in U.S. federal court. The courts agreed with the SEC's argument that foreign banking secrecy law should not be allowed to provide a cover for insider traders seeking to defraud American investors. The courts thus imposed hefty fines, prompting the banks to cooperate and to reveal the identities of those who had placed the orders in question. The information enabled the SEC to show that the orders had indeed been placed illegally by insiders with prior information of the upcoming transactions. In the resulting settlements, the trades' originators had to forfeit all illegally obtained profits and were heavily fined.

Following the two incidents, Swiss authorities were eager to avoid another confrontation and approached the SEC to solve the problem of cross-border securities law enforcement. Existing tools for cross-border law enforcement, such as MLATs, would not work as long as insider trading remained legal in Switzerland and the Swiss made clear they had no intention of changing their domestic law. Swiss regulators therefore proposed an informal, non-binding Memorandum of Understanding between the two sides to regulate the exchange of information in

cases of suspected insider trading in U.S. markets carried out through banks located in Switzerland. Negotiations began in March 1982 and, as SEC Commissioner Richard B. Smith noted, “[t]o the amazement of many observers, by the end of August of 1982 [...] a memorandum of understanding did result, the first MoU” (Smith 1988).⁴ Swiss banks agreed to provide information on their customers despite local banking secrecy laws if the SEC had strong evidence that insider trading or a similarly fraudulent act had occurred. Information requests would be sent by the SEC to the Swiss Banking Association which would then pass them on to the bank in question.

In dramatic fashion, the two high-profile cross-border insider trading cases opened the SEC’s eyes to the challenge of dissimilar national securities regulation and pervasive foreign banking secrecy laws in the context of globally integrating financial markets. U.S. regulators saw the MoU with Switzerland merely as a quick fix, not a real solution. On the eve of the SEC’s 50th anniversary, Commissioner Bevis Longstreth (1983) laid out the new challenge the agency faced:

The growing internationalization of the securities markets will pose [a] challenge for the Commission in the coming years. As advances in communications technology make the situs of trading in securities less important, the Commission will face increasing difficulty in ensuring that its investor protections reach all transactions in world class securities effected by or for the benefit of U.S. citizens. Leadership in developing an appropriate international system of securities regulation will present an important challenge to the Commission in the years ahead. As transactions become easier to accomplish abroad, the Commission will become increasingly tempted to lower its standards of investor protection in order to prevent the flight of securities transactions beyond its reach. The trick will be to encourage the securities regulators of the other major trading nations to develop systems that provide protections to investors substantially similar to those provided in this country while trimming away regulations that are not essential to assure those protections.

The Commissioner thus called on his agency to take the lead, work with foreign regulators, and thereby promote the adoption of U.S. standards around the world. However, the agency’s first response was anything but cooperative. To solve the problem of foreign banking secrecy laws once and for all, the SEC’s enforcement division proposed to enact a new rule dubbed “waiver-by-conduct.” The idea was that any foreigner trading in U.S. markets – by the very act of placing

⁴ For a detailed analysis of the first MoU, see Mann, Mari and Lavdas 1995, Smith 1988.

an order – had agreed to waive all protection afforded under foreign banking secrecy laws (Fedders et al. 1984; Kübler 1987). To the dismay of its authors, the proposal was short-lived. U.S. banks, securities houses, law firms, the NYSE and NASDAQ, prominent academics, foreign governments, and even the U.S. Treasury Department uniformly came out against the attempt to unilaterally apply U.S. rules extraterritorially. Whereas the private sector and the stock exchanges were afraid the rule could drive business away from U.S. markets, foreign governments warned against an infringement of their sovereignty. Moreover, most experts agreed that “waiver-by-conduct” would not work and urged extensive cooperation with foreign regulators instead (Boyle and Thau 1984; Bschorr 1984; Capitani 1984). Several commentators explicitly mentioned the Swiss MoU as a positive precedent on which to build.

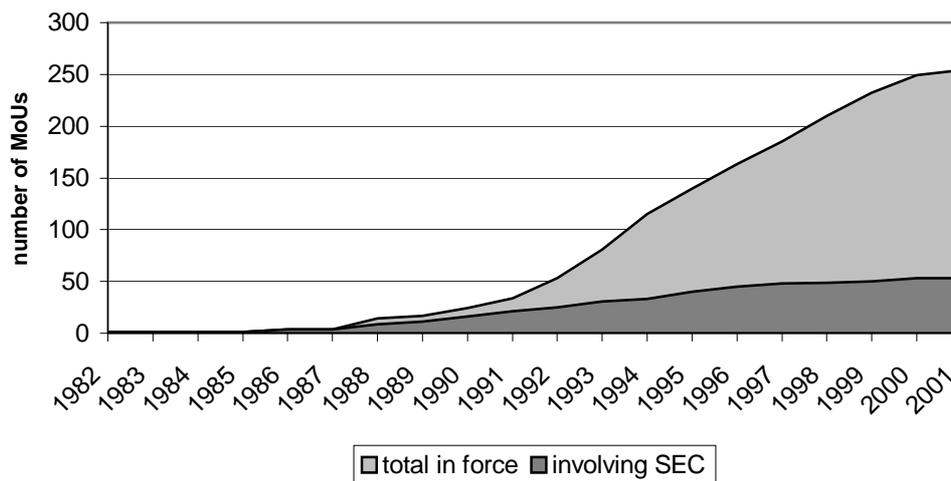
Having witnessed the quick death of its plan to unilaterally apply U.S. rules to foreigners trading in U.S. markets, the SEC heeded the call of its critics and rededicated itself to cooperation. It developed an ambitious two-pronged strategy, combining both bilateral and multilateral elements. Building on the Swiss precedent, between May 1986 and August 1988, the SEC negotiated and signed MoUs with securities regulators from Japan, the UK, Canada, and Brazil (Jiminez 1990; Smith 1988). At the same time, the SEC became a principal proponent of the creation of a discussion forum for the world’s securities regulators. It led the process of turning the Inter-American Association of Securities Commissions and Similar Agencies (IAASC) – a fairly ineffective organization created in 1974 at the urging of the World Bank – into the International Organization of Securities Commissions (IOSCO). The *Financial Times* lauded the move at the time, arguing the club of regulators had successfully “transformed itself from an American talk shop into an embryonic global securities organization.”⁵

⁵ “Watchdogs To Bark In Tune,” *Financial Times* 21 July 1986, Sec. I, p. 16.

Development and Institutionalization

Both elements of the SEC’s cooperation strategy have been thoroughly institutionalized over the past two decades. Following the initial set of MoUs, the SEC negotiated more than thirty additional agreements in the 1990s. More importantly, the model of information exchange and enforcement cooperation on the basis of informal MoUs rather than cumbersome international treaties caught on. By 2000, a total of more than 250 MoUs had been concluded between securities regulators around the world. The share involving the SEC falling has consequently been falling over time (Figure 2).⁶

Figure 2: Securities MoUs in force and share involving SEC



MoUs establish simple procedures on the basis of which regulators from two or more jurisdictions share information in an effort to combat cross-border securities fraud or assist each other in other ways. Bilateral information and assistance requests have become routine practice among the world’s securities regulators over the last fifteen years or so. A sign of increasing

⁶ IOSCO keeps a list of MoUs and similar agreements on its website. For simplicity, we refer here to all of these agreements as “MoUs” even though some of them are “Administrative Agreements”, “Communiqués”, or “Letters of Intent.” Regardless of the official name, all are informal, non-binding statements among regulators that establish procedures for information sharing, enforcement cooperation, and, at times, technical assistance.

financial integration but also growing international cooperation, assistance requests to and from the SEC steadily grew during the 1990s (Table 1).

Table 1: International Assistance Requests involving the SEC

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
SEC requests to foreign authorities	145	191	213	223	230	230	240	275	336	345
Foreign requests to the SEC	160	184	232	296	337	342	363	412	550	519

Source: SEC, annual reports

In addition to requests for information and enforcement assistance, requests for technical assistance have further cemented international cooperation among regulators. As Raustiala (2002) explains, “securities regulators from the U.S. are providing extensive technical advice, training personnel, and drafting legislation for regulators in emerging markets.” In 2000 alone, the SEC received some 222 requests for technical assistance, mostly from regulators in emerging markets. A similar number were received in 1999. The SEC also organizes training seminars for foreign regulators. A total of 670 regulators from 65 countries have participated in the agency’s annual International Institute for Securities Enforcement and Market Oversight (Raustiala 2002). In 2000, the SEC trained 460 securities regulators from 71 countries in the U.S., and at least another 245 in seminars abroad (SEC 2001). The previous year, the SEC provided training for 345 officials from 93 countries and trained an additional 530 abroad (SEC 2000).

Training and technical assistance offered by leading regulators such as the SEC has been complemented by multilateral efforts led by and coordinated through IOSCO. Now counting regulators from more than one hundred jurisdictions among its members, IOSCO has become the

principal body for the development of regulatory standards and best practices. In 1987, regulators meeting at IOSCO's Annual Conference adopted the Rio Declaration, which called on regulators to cooperate with one another to combat international securities fraud and to work towards harmonization of regulation. IOSCO formally became involved in the MoU process when it began to serve as a depository for agreements among its members. It formally adopted Principles of Memoranda of Understanding in 1991 and thereby supplied a focal point for subsequent bilateral negotiations among its members. This "model MoU" became the blueprint for many MoUs negotiated during the 1990s, particularly those involving regulators from emerging markets.

Yet IOSCO has extended its work beyond facilitating bilateral cooperation among its members. The working groups of IOSCO's Technical Committee have established a variety of standards and benchmarks that have become regulatory practice around the world. These include recommendations for dealing with derivatives trading, the regulation of financial conglomerates, clearing and settlement systems, and alternative trading systems, as well as harmonized standards for non-financial disclosure by foreign issuers. Perhaps most importantly, in 1998, IOSCO adopted *Objectives and Principles of Securities Regulation* (IOSCO 2003), a set of benchmarks, best practices and reference points developed under U.S. leadership that have served as a blueprint for the development of regulatory regimes around the world, particularly in emerging markets (Raustiala 2002). By explicitly calling on members to ensure regulation prohibits "market manipulation, misleading conduct, insider trading and other fraudulent or deceptive conduct which may distort the price discovery system, distort price and unfairly disadvantage investors" (IOSCO 2003), the document effectively closes the loop that began with the SEC's frustration over the effects of permissive Swiss regulation in the early 1980s.

V. Data and Methodology

For the empirical analysis we employ discrete event history analysis. This approach has established itself as the method of choice for studies of international diffusion processes (Elkins, Guzman, and Simmons forthcoming 2006; Henisz, Zelner, and Guillén 2005; Simmons and Elkins 2004; True and Mintrom 2001). Event history analysis explores the probability that a unit will experience a particular event in a given time, given that that the event has not already transpired. This probability is termed the hazard rate (Box-Steffensmeier and Jones 2004). In our case, we first employ event history analysis to estimate the hazard rate for the adoption of insider trading regulation. We then conduct a second analysis estimating the hazard rate for the first prosecution of an insider trading case based on new regulation. In both cases, the dependent variable is coded “0” in every year that the country is at risk (of adoption or enforcement) and “1” in the year that the event occurs. A country is at risk for adoption starting in the year it establishes a stock market. A country is at risk for enforcement from the year in which it adopts insider trading regulation. In each case, the country falls out of the analysis once it has experienced the event. This means that several countries, including the U.S., France, and Canada, which adopted and enforced insider trading regulation prior to the period under investigation, are not included in the statistical analysis. Following the work of True and Mintrom (2001) and Box-Steffensmeier and Jones (2004), we employ logit regressions. Using the rare events logit estimator developed by King, Tomz, and Zeng (2001), we correct for the small number of events in the dataset.⁷ To account for duration and time dependencies, we include a polynomial cubic count variable (Carter and Signorino 2006).⁸

⁷ We also employed standard logit estimates and obtained similar results.

⁸ We also used grouped time fixed effects and obtained similar results.

Our sample includes 114 countries over the period from 1977 to 2004. We chose 1977 as the start date to begin the analysis five years before the onset of modern regulatory cooperation in the securities industry, symbolized by the first MoU between the U.S. and Switzerland in 1982. The 114 countries comprise all countries that had stock exchanges in 2004. Most of the data on the status of insider trading regulation come from Bhattacharya and Daouk (2002). They surveyed regulators in more than 100 jurisdictions to identify countries that had (a) adopted and (b) enforced insider trading regulation up to 1998. We then updated and expanded their original dataset, both with respect to time and the number of countries.

Explanatory Variables

Variables capturing the hypothesized effects of *domestic drivers* of policy adoption are all fairly standard and straightforward. We capture the effect of legal tradition – civil or common – with a dummy variable, a score of “0” for civil law countries and “1” for common law countries. Similarly, countries that have an independent central bank in a given year are scored “1” whereas those that do not have a “0”. We measure the extent of individual rights through the Freedom House Index where countries are measured on a scale from 1 (free) to 7 (not free). To capture the potential effect of stock market maturity and importance, we employ measures of the stock market’s age and its capitalization as a ratio of GDP (Beny 2002).⁹ In addition, we control for GDP per capita and a country’s international openness as measured by the ratio of exports and imports to GDP. Lastly, we control for the effects of political transition from communism. Many countries in our dataset underwent a sudden market making process, which could account

⁹ We also employed variables that capture stock market turnover. However, these did not produce any significant results.

for the rapid adoption of insider trading rules. A dummy variable identifies countries that were formerly communist and have undergone such a transition.

As noted in the discussion of mechanisms, there is no direct *coercion* in the securities field. However, there are two indirect causal pathways potentially linking coercive pressures to adoption and enforcement decisions. One rests on the extraterritorial reach of U.S. law through requirements for foreign firms listing on U.S. exchanges. This is “trading up” effect is captured by a dummy variable with a score of “1” for any country that has at least one firm listed on the New York Stock Exchange in a given year and a “0” for those that do not. On the European side, the 1989 Insider Dealing Directive puts extraterritorial pressure on existing member states that had previously not banned insider trading and on new candidates for membership that have to comply with the *acquis communautaire*. We employ a dummy variable that is “1” for all EC member states starting in 1989, and for accession countries in the year in which they formally began the accession process.

We employ a measure developed by Simmons and Elkins (2004) to capture the hypothesized effects of economic *competition*. Recognizing that countries compete for international capital in clusters – i.e. investors are more likely to choose between, say, the Netherlands and Denmark than the Netherlands and Ghana –, they identify for each year and country the set of countries most similar in terms of investment profile and assess the percentage among them that has adopted the policy. The larger the share of adopters among countries that compete for the same type of investment capital, the greater the probability a laggard will follow suit. Identifying for each country-year the ten most similar countries in terms of investment profile, we compute the average score among them for both adoption and enforcement. A “0” thus indicates that none of a country’s capital competitors has adopted (enforced) insider trading regulation and a “1”, conversely, indicates that all have. We identify each country’s top ten

capital competitors in a given year through a dyadic distance measure developed by Simmons and Elkins.

Our operationalization of *learning*, as noted above, focuses on learning from successful countries. Having identified the fastest growing countries in a given year, we computed the percentage among them that had either adopted or enforced insider trading regulation. The larger the share among them, one would suppose, the stronger the signal that banning insider trading “works” and the greater the incentives for followers to learn from leaders’ success.

Whereas learning assesses the policies of the most successful, the effect of *emulation* is captured by the prevailing policies of other reference groups. Just as we calculated average scores for both capital competitors and high-growth countries, we do the same for each country’s neighbors and countries that are similar in terms of prevailing religion – predominantly Christian, Muslim, Buddhist, Hindu, Jewish, or without a dominant religion. We focus on religion rather than other cultural attributes because it is the only measure in this category that returned significant results in a similar previous study (Simmons and Elkins 2004). We also include the global average policy score as a marker of a more general, normative trend.

Finally, *persuasion*, as discussed, is modeled as the effect of participation in the transgovernmental regulatory network that has developed since the mid-1980s. Through dummy variables, we capture whether a jurisdiction’s regulator is a member of IOSCO in a given year and whether or not the regulator has an MoU in force with another regulator.

All of the diffusion variables were lagged two years against the dependent variable. Fixed effects time dummy variables were constructed for each part of the analysis. Table 2 presents summary statistics.

Table 2: Descriptive Statistics

Mechanism	Variable	Minimum	Maximum	Mean	SD	Source
Dependent Variables	Insider trading policy	0	1	0.08	0.27	(1)
	Enforcement of insider trading policy	0	1	0.06	0.24	(1)
Domestic Drivers and Controls	Stock exchange capitalization/GDP	0	5.49	0.38	0.52	(2)
	Age of Stock Exchange	0	419	51.08	74.11	(3)
	Legal tradition	0	1	0.33	0.47	(4)
	Central bank independence	0	1	0.38	0.49	(5)
	Extent of personal freedom	1	7	3.31	1.90	(6)
	Trade openness	0.06	3.31	0.76	0.44	(2)
	GDP per capita (USD)	136.05	47926.27	7380.81	9014.13	(2)
	Post-Communist Transition	0	1	0.22	0.41	(13)
Coercion	Firm listed on NYSE	0	1	0.17	0.38	(12)
	Presence of EU Directive	0	1	0.10	0.29	(7)
Competition	Policies (adopt) of capital competitors	0	1	0.35	0.37	(1, 8)
	Policies (enforce) of capital competitors	0	1	0.15	0.22	(1, 8)
Learning	Policies (adopt) of high-growth countries	0	0.47	0.22	0.16	(1, 2)
	Policies (enforce) of high-growth countries	0	0.26	0.07	0.07	(1, 2)
Emulation	Policies (adopt) of neighbors	0	1	0.33	0.36	(1, 9)
	Policies (enforce) of neighbors	0	1	0.16	0.28	(1, 9)
	Policies (adopt) of religion partners	0	1	0.43	0.30	(1, 10)
	Policies (enforce) of religion partners	0	1	0.16	0.16	(1, 10)
	Global Average of Countries (adopt)	0.14	0.97	0.58	0.30	(1)
	Global Average of Countries (enforce)	0.05	0.44	0.21	0.14	(1)
	Persuasion	IOSCO membership	0	1	0.44	0.49
	MoU in force	0	1	0.26	0.44	(11)

Sources: (1) Bhattacharya and Daouk 2002, complementary author surveys; (2) World Bank; (3) Beny 2002; (4) Beny 2002; (5) McNamara and Castro 2003; (6) Freedom House; (7) Simmons and Elkins 2004; (8) European Union; (9) Stinnett et al. 2002; (10) CIA World Factbook; (11) IOSCO; (12) NYSE (13); various sources.

VI. Findings

Adoption of Insider Trading Regulation

The analysis of the variables identified yields an interesting, yet complex result. Only three variables – the global average adoption score, the variable capturing the effects of foreign listings on U.S. markets, and post communist transition – show statistically significant results in the full model specification (table 3). The signs of all three significant variables are in the expected direction as a higher global average, the presence of firms in U.S. markets, and the fact of a post-communist transition all increase the likelihood of adoption. The three variables represent three very different, yet not necessarily incompatible causal mechanisms. The global average score captures emulation, but emulation of a general systemic trend rather than emulation of the policies of specific reference groups. Indirect coercion in the form envisioned by Vogel and others in the “trading up”-paradigm also appears to play a role. Lastly, controlling for everything else, including international pressures, countries having undergone a domestic political transformation following the end of communism are considerably more likely to adopt insider trading regulation than non-transition countries. Combined with the importance of the global average score, this does suggest that there is a growing consensus that insider trading is incompatible with modern securities markets.

While the result is thus consistent with some of the arguments put forth in the policy diffusion literature, the lack of support for other prominent mechanisms and variables in this field is striking (models 3 and 4). Variables capturing competition and learning, for example, do not yield significant results. This is particularly surprising as these two mechanisms play important roles in studies of economic liberalization (Henisz, Zelner, and Guillén 2005; Simmons and Elkins 2004). Emulation of specific reference groups – neighbors or countries sharing the same

dominant religion – also does not appear to play a major role in domestic adoption of insider trading rules.

Apart from the effect of post-communist transition, domestic variables offer little explanation for the adoption of insider trading rules. In model 2, none of the political variables are statistically significant. In model 1, GDP per capita does prove to be statistically significant, indicating some support for the modernization argument. The effect disappears, however, as other variables are included in the analysis. The cubic polynomial count control is significant in most of the models, demonstrating a time dependency frequent in diffusion models.

Table 3: Event History Analysis for the Adoption of Insider Trading Regulation

Variables	(1) Economic Modernization	(2) Internal Political	(3) Diffusion	(4) Diffusion with Controls
EU Coercion			1.03	.69
Capital Competitors			-.29	.02
Fast Growth Countries			.012	-1.7
Neighbor Adoption			-.39	-.45
Religious Group			.528	.14
Global Average			10.29 (p=.055)	13.7*
IOSCO Member			.405	.49
MoU Partner			-.54	-.14
US Coercion			.946*	1.02*
Post Communist			.72	1.5**
GDP per capita	.00003*		.	.00004
Trade Openness	.1139			
Age of Stock Exchange	-.0032			-.0027
Freedom		-.053		-.051
Common Law		.098		.78
Central Bank Indep.		.248		
Time	-.56**	-.47**	-.40*	-.55**
Time Squared	.07**	.05**	.04*	.06**
Time Cubed	-.002**	-.00**	-.001	-.002**
Number of Obs.	941	728	923	845

* indicates significant at the .05 level. ** Indicates significant at the .01 level.

Enforcement of Insider Trading Legislation

The results concerning the enforcement of newly enacted insider trading bans provide an intriguing contrast to the results for adoption (table 4). Indirect U.S. coercion via stock market listings in New York no longer has a statistically significant effect. A new external variable, in contrast, is significant and robust. Membership in IOSCO significantly increases the likelihood that a country will enforce insider trading legislation. IOSCO membership captures participation in the transgovernmental network of securities regulators that seeks to strengthen international securities law enforcement through cooperation, best practice development, and training. Network participation thus does appear to have an effect, but the effect is entirely on the enforcement side, not when it comes to adoption.

Table 3: Even History Analysis for the Enforcement of Insider Trading Regulation

Variables	(1) Economic Modernization	(2) Internal Political	(3) Diffusion	(4) Diffusion with Controls
EU Coercion			.68	-.21
US Coercion			.52	.11
Capital Competitors			-.5	.44
Fast Growth Countries			1.37	2.4
Neighbor Adoption			.27	.21
Religious Group			-3.5*	-3
Global Average			5.4	7.5
IOSCO Member			1.02*	1.07*
MoU Partner			.58	.47
Post Communism			.82	1.8**
GDP per capita	.00006**		.	.0007**
Age of Stock Exchange	.0047*			.004
Stock Mrkt Cap/GDP	.6459			
Freedom House		-.248*		-.026
Common Law		-.149		.226

Time	.214	.09	.106	.07
Time Squared	-.013	-.005	-.01	.0009
Time Cubed	.0003	.0002	.0003	-.00002
Number of Obs.	799	802	807	786

* Indicates significant at the .05 level. ** Indicates significant at the .01 level.

Besides IOSCO membership, two other variables return statistically significant results. Post-communist transition is the only variable that increases the likelihood of both adoption and enforcement. In contrast, other variables capturing emulation or learning mechanisms are not significant. The same is true for competition. GDP per capita, however, is significant, suggesting that richer countries are more likely to detect and prosecute cases of insider trading than poorer ones. But none of the other domestic variables are statistically significant.

VII. Conclusion

This paper provides an initial exploration of the drivers behind the adoption and enforcement of insider trading regulation over the last thirty years. The results, while preliminary, are provocative for scholars of both diffusion and transgovernmental networks. First, the results suggest that the mechanisms that promote policy adoption are mostly distinct from those that promote policy enforcement. This finding should motivate researchers to move beyond studies of policy innovation and examine events further down in the policy stream including implementation. In the case of insider trading legislation, U.S. policy has played an important role. Yet it has worked through different causal pathways for adoption and for enforcement. Indirect coercion through listing requirements for foreign firms in the U.S. appears to promote foreign adoption. It does not, however, promote enforcement. The likelihood of enforcement, in turn, increases with participation in a transgovernmental network that had its origins with conscious U.S. efforts to boost international securities market regulation through

cooperation. The paper thus finds support for the claim that policy networks are an important external driver of domestic policy change and offers a first quantitative assessment of the effects of these networks. In particular it strengthens the findings of qualitative studies that have emphasized the role of transgovernmental networks in domestic regulatory capacity building.

Secondly, the paper finds that competition and learning from success – two prominent mechanisms that have been found to be at work in the diffusion of other policies – do not appear to drive dynamics in the case of insider trading. The lack of support for the competition effect is particularly surprising as research clearly shows that countries with better securities regulation can more easily attract capital. Emulation and indirect coercion in the case of adoption as well as persuasion and learning through the transgovernmental network in the case of enforcement appear to be more important than competition for capital.

Thirdly, the results focus attention on the role of post-communist transition, a variable that has so far not featured prominently in international diffusion studies. Controlling for a broad range of other factors – including the trend of time and the demands of EU membership – we find that countries having undergone a transition from communism are more likely to both adopt and enforce insider trading regulation than those that have not. One possibility is that these countries have embraced Western market institutions with a vengeance and that this embrace goes beyond mere policy adoption. But whereas a strong embrace of Western securities market regulation would perhaps explain a greater willingness to enforce, it alone cannot explain why post-communist transition countries appear to have been effective in their enforcement efforts. In a future iteration of this paper we hope to explore the interaction of post-communist transition with other variables more closely.

Financial market regulation occupies a critical place in the fabric of global governance. The rapid spread of U.S.-style securities market regulation and of rules banning insider trading in

particular over the past three decades poses an intriguing puzzle. This paper has shed some light on critical mechanism at play and has found evidence for the important role played by policy networks. More work is needed to confirm the robustness of these findings. But even at this preliminary stage, the paper shows that the intersection of policy diffusion and transgovernmental regulatory cooperation offers a rich and challenging terrain for studying the interplay of globalization, global governance, and domestic market regulation.

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