



Inter-jurisdictional Regulatory Recognition: Facilitating Recovery and Streamlining Regulation

June 2012

A report from the

EU-US Coalition on Financial Regulation

Coalition members:

American Bankers Association Securities Association (ABASA)

Association of Financial Markets in Europe (AFME)

Bankers' Association for Finance and Trade (BAFT)

British Bankers' Association (BBA)

Futures Industry Association (FIA)

Futures and Options Association (FOA)
(*Secretariat for the Coalition*)

International Capital Market Association (ICMA)

Investment Industry Association of Canada (IIAC)

International Swaps and Derivatives Association (ISDA)

Securities Industry and Financial Markets Association (SIFMA)

Swiss Bankers Association (SBA)

CONTENTS

I. PRE-CRISIS REGULATORY RECOGNITION	4
1. THE REGULATORY JUSTIFICATION FOR RECOGNITION	5
2. The Commercial Justification For Recognition	6
3. Progress Towards Implementation Prior To The Crisis	7
II. IMPACT OF THE CRISIS ON REGULATORY RECOGNITION	8
1. Re-prioritisation of regulatory policy.....	8
2. Consideration and rejection of "Balkanisation" as a regulatory response.....	9
3. Enhanced awareness of the problems of recognition	11
4. Enhanced awareness of the advantages of international co-operation	12
III. Post-crisis Mutual Recognition	14
1. The present position and way forward.....	14
2. Extraterritoriality	15
3. The international standard-setters	16
IV. The Intellectual Architecture Of Regulatory Recognition Post-Crisis	17
1. Approaches to recognition	17
2. Bases for mutual recognition.....	18
3. Assessing whether the preconditions for mutual recognition are in place –shared regulatory objectives are central.....	19
4. Prioritisation of regulatory overlaps	20
5. Threshold criteria for implementing post-crisis regulatory recognition; significance of lead supervisor approach in certain contexts	20
6. Further areas where mutual recognition could provide benefits	24
7. The IOSCO Principles of Securities Regulation (2010).....	25
V. Conclusion	27
APPENDIX 1 – EU-US Coalition on Financial Regulation – Background Briefing Note.....	29
APPENDIX II - Objectives and Principles of Securities Regulation (2010)	34
APPENDIX III – Joint association letter from GFMA, IBFED and ISDA	38

INTER-JURISDICTIONAL REGULATORY RECOGNITION: FACILITATING ECONOMIC RECOVERY AND REGULATORY EFFICIENCY

BACKGROUND

In 2005, a group of transatlantic trade associations in the financial services sector established the EU-US Coalition on Financial Regulation to encourage governments and regulatory authorities on both sides of the Atlantic to progress inter-jurisdictional regulatory recognition and exemptive relief on the basis of regulatory compatibility and, where possible and appropriate, rules' convergence. The overall objective was to facilitate customer choice and market access and establish a more coherent framework for the effective regulation of cross-border financial services business (see Appendix 1).

This reports updates and expands on the Coalition's earlier pre-crisis reports by emphasising the importance of exemptive relief and regulatory recognition (whether unilateral, bilateral or multilateral) based on common regulatory values and shared outcomes (and the need for targeted rules' standardisation where either (i) there is insufficient approximation in rules' outputs to facilitate recognition; or (ii) standardisation or convergence would deliver regulatory coherence, efficiency , cost-effectiveness and tangible benefits to business.

The Coalition recognises entirely that regulatory authorities must be able to engage in confidential regulator-to-regulator dialogues, but believes also in the importance of a separate dialogue being maintained with industry participants (both the sellers and consumers of financial products and services), market infrastructures and their representative bodies in order to ensure that the commercial and business benefits alongside the regulatory benefits are given due consideration.

The conclusions reached in this paper are the result of a process of consultation with all the industry associations who are members of the Coalition and major firms that are particularly engaged in transatlantic financial services business.

INTRODUCTION

Transatlantic relationships are largely founded on common commercial and political goals and values, and upon the free-flow exchange of ideas, persons, products, services and technology. In financial services, these linkages are evidenced by the increasingly transatlantic nature of capital and derivative markets as evidenced by market statistics. The U.S.-EU economic relationship dominates the world economy by the sheer size of the combined economies. The combined population of the United States and the EU members approaches 800 million people who generate a combined gross domestic product (GDP) that is roughly equivalent to 40% of world GDP in 2010. Combined EU and U.S. trade accounts for over 47% of all world trade. Together, the two regions account for 80% of global financial services business. Indeed, a large part of the prevailing framework of regulation in financial services in Europe, Canada, Australia, Switzerland and many other jurisdictions is built on the original regulatory approach of the US authorities.

Unfortunately, despite the good work of a number of international groups (e.g. the informal transatlantic Financial Markets Regulatory Dialogue (FMRD) and the more formal harmonisation of standards and principles, particularly by IOSCO), the rules, processes and priorities of regulatory authorities continue to be largely geographically based and governed by differentiated national laws. This has resulted in a complex and costly meld of duplicative and sometimes conflicting regulations and processes, which sit uneasily with the increasingly global nature of financial markets and services.

Prior to 2008, perhaps not surprisingly, there was broad consensus between regulators and firms that international co-ordination was a necessary part of improving the efficiency and effectiveness of the regulation of cross-border financial business and services. This is as true today as it was then. The difference is that prior to the crisis the general belief was that regulation was broadly effective, and the challenge was to make it more efficient. After the crisis, the general belief is that regulation needs to be made more effective as well as more efficient. The "three gateways" of exemptive relief to avoid duplication of effort, mutual recognition to enable regulators to rely on each other in terms of extraterritorial actions and supervision, and cross-border harmonisation of key rules all have a continuing part to play in delivering this outcome. This will enable customers to benefit from being able to exercise more choice and to better negotiate a reduction in their "pass-on" costs; compatible regulatory authorities to work together more efficiently and for firms to carry on their cross-border business with more coherent compliance and less legal risk.

The time to start thinking about global co-ordination and mutual recognition is at the start of the legislative process – and particularly now, as authorities on both sides of the Atlantic converge their agendas for regulatory repair in accordance with internationally-set standards. This is the time when negotiations on the post-crisis basis for the "three gateways" must be taken forward with and where there is opportunity to identify any key regulatory differences in the restructuring. If legislation is formulated with a view to convergence in the programmes for regulatory repair and facilitating co-operation between accredited regulatory authorities, the outcome is likely to be both more efficient and more effective than would otherwise be the case. As the G20 programme reaches its implementation stage, it is important for both lawmakers and regulatory authorities to keep legislation, rulebooks and regulatory processes under review for the purpose of facilitating and improving regulatory convergence, coherent implementation and mutual co-operation.

Aside from firms looking to recover and expand their businesses and customers wishing to diversify investments and enlarge choice of providers, the key beneficiary of regulatory recognition, exemptive relief and closer rules convergence will be the regulatory authorities themselves. It is clear that they are facing significant increases in their responsibilities with little or no increase in their resources. In order to discharge those responsibilities to a high standard, regulators have to co-operate so significantly more closely together in the sharing of information and the supervision and enforcement of cross-border business – and that means placing reliance on the licensing and supervision of foreign financial firms and markets based in comparably regulated jurisdictions. The increased post-crisis challenges facing national regulators in terms of the macro- and micro-supervision of international business is that establishing inter-reliance between compatible regulators and delivering on the "three

gateways” (identified earlier in this summary) have now become an essential element of the global regulatory agenda.

As to the basis of facilitating recognition, it must be rational, realistic and reliable, recognising that no two jurisdictions will necessarily be exactly the same, i.e. there will be differences in legal systems, market structures and regulatory resources and experience. This means, in turn, that different degrees of inter-reliance will have to be accommodated in memoranda of understanding and shared supervisory arrangements. Indeed, as things stand at present, they may have to vary significantly.

The post-crisis drive to ensure that national and regional programmes for regulatory repair are broadly in line with an increasing number and range of regulatory standards set at a global level will help to underpin the recognition condition of equivalence. However, a requirement for full or strict equivalence by a host state could be tantamount to closing its domestic market to overseas participants and narrowing customer choice. As a result, this should only be required in extreme circumstances where there is no other practical way of protecting domestic customers.

In the matter of supervision, there are no globally-set standards and supervisory practices vary significantly between jurisdictions. Consequently, regulators seeking to pursue mutual recognition approaches will be obliged to assess not only the regulatory rules and standards in particular jurisdictions, but also approaches to supervision and enforcement in those jurisdictions; and that these determinations will be based on an assessment of the effectiveness of the supervisor as well as of the effectiveness of the legal basis upon which the supervisor supervises. However, it should also be recognised that the supervisory practices established in one jurisdiction are likely to be adapted to the facts of that jurisdiction – different jurisdictions need to be supervised in different ways. Thus a lack of commonality in supervisory approaches should not be assumed to be a defect in supervisory standards.

I. PRE-CRISIS REGULATORY RECOGNITION

In the years leading up to the financial crisis, considerable progress had been made between the EU and the US in improving the regulation of global financial services. The approach on both sides of the Atlantic was based on the belief that effective regulatory models were in place, and the challenge was to make them more efficient by addressing overlaps and inconsistencies between them.

In April 2007, the EU-US Summit in Washington, amongst its other conclusions, called for an acceleration towards *“convergence, equivalence or mutual recognition, where appropriate, of regulatory standards based on high quality principles”*.

On 1st February 2008, in furtherance of that objective, the EU Commission and the US SEC, in their Joint Statement on Mutual Recognition in Securities Markets, committed their organisations to transatlantic financial market integration and mandated their respective staffs to *“intensify work on a possible framework for EU-US mutual recognition for securities in 2008”* on the basis that their respective regulatory frameworks were built on largely shared

regulatory and public policy objectives. As the Joint Statement put it, *“the concept of mutual recognition offers significant promise as a means of better protecting investors, fostering capital formation and maintaining fair, orderly and efficient transatlantic securities markets”*.

In furtherance of this commitment, the SEC issued a consultation paper on 27 June 2008, putting forward proposals for simplifying Rule 15(a)-6 in order to offer a more straightforward and less complex framework of exemptive relief for non-US broker dealers to be able to carry on certain activities with or for certain US institutional customers. The proposals were broadly compatible with the exemptive relief already offered to US broker-dealers in some EU member states and reflective of the calls for greater investment, capital raising and trading choice by US institutions.

In 2008, as a result of the emergence of the crisis, the work that had been commenced by the European Commission and the SEC to establish a framework for EU-US mutual recognition and the SEC consultation on reviewing its Rule 15(a)-6 was suspended in order to facilitate priority work in redesigning, reforming and strengthening regulation in both the EU and the US.

1. THE REGULATORY JUSTIFICATION FOR RECOGNITION

By 2008 it was generally accepted that regulatory harmonisation was a desirable policy goal in its own right. At the time the focus of policy was primarily on improving the efficiency of the regulatory oversight of cross-border financial services business and the elimination of overlapping, duplicative or conflicting rules and regulatory functions through recognition of and enhanced inter-reliance between compatible regulatory authorities.

The effort to eliminate overlapping, duplicative or conflicting regulatory activities was given further impetus by the realisation that regulatory overlaps were set to increase as the industry became increasingly globalised. Cross-border business was an increasing proportion of absolute levels of business, and was perceived (correctly) as an area where the mandate on regulators to regulate effectively would exist for many years before legislative harmonisation could be complete. In many respects mutual recognition can be regarded as an interim step, aimed at dealing with the tensions which necessarily afflict global regulators after global business has become established and before global harmonisation of regulation can be effected.

This point was further emphasised by the fact that the state of the global financial markets required frequent and substantial interaction between different national regulators in any event. The "colleges of supervisors" approach to the regulation of larger global entities was well-established by the beginning of the 1990s, but in the ensuing period it became clear that the application of the firm-specific approach could not be pursued in respect of to every internationally active firm, since almost all firms were, to some degree or another, international. The acquisition of a working knowledge of the supervisory regimes in other major jurisdictions became a commonplace of life for many supervisors.

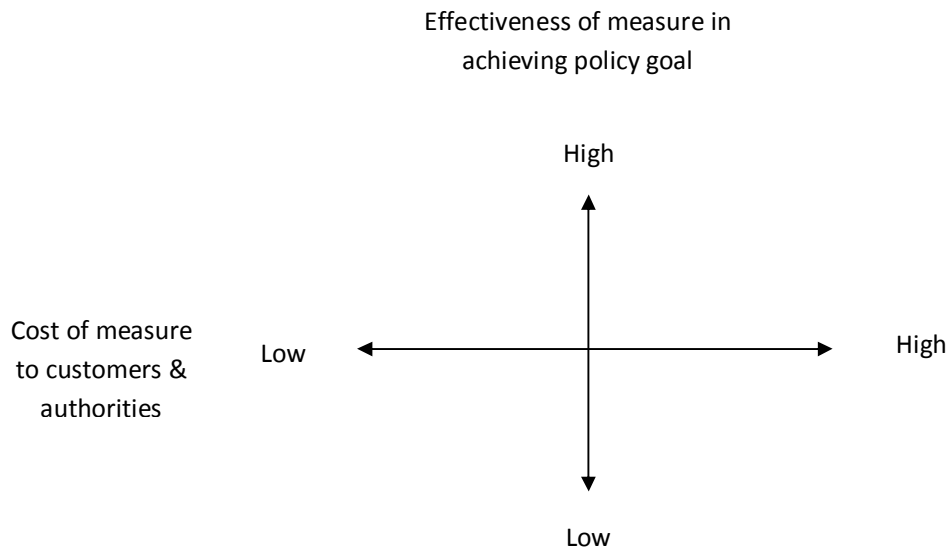
This in turn led to multilateral interaction and a plethora of Memoranda of Understanding (MOUs) between regulatory authorities, both as regards the development of regulatory responses to particular issues and as regards supervisory processes. As this developed, two conflicting tendencies began to develop. One was a realisation of the sometimes significant

differences in overarching legal frameworks and regulatory techniques used in different jurisdictions to achieve similar goals, giving rise to a perception of substantial divergence between regimes. The other was the conclusion that, although the techniques used might differ, the objectives of many regimes were broadly identical, and that the true measure was the effectiveness of achievement of these aims, and on this measure, divergences between regimes were not as significant as appeared to be the case.

2. The Commercial Justification For Recognition

Financial regulation can be assessed on a two-by-two matrix as follows

Fig 1. Classification of regulatory measures



Although the primary aim of regulatory policymaking is to ensure that policies fall towards the top half of the matrix, there is also a strong policy incentive to reduce the cost impact on customers and regulatory authorities themselves as well as for market participants – that is, to move towards the left of the matrix. The effect of mutual recognition measures – based on regime analysis to ensure compatibility with a specific objective for enhancing regulatory effectiveness – is to move groups of regulations towards the lower-cost end, thereby increasing overall efficiency and consumer and authority benefit for no cost. Mutual recognition, properly and effectively done, is therefore a tool for creating benefits without costs.

It is important to distinguish between mutual recognition and legislative harmonisation, and to recognise that these are separate policy goals which can be pursued independently along different paths at different speeds, although their ultimate outcomes are likely to converge. However, it should also be noted that in the same way that regulatory and market efficiency can be improved by mutual recognition of convergent processes, market efficiency and consumer benefit can also be created by legislative harmonisation as an end in itself. More importantly for these purposes, however, legislative harmonisation can significantly simplify

the process of making mutual recognition determinations, since it reduces the burden imposed on regulators in analysing discrepant regimes. This in turn promotes competition, and contributes to a wide range of societal benefits, including open access to markets, choice and diversity, enhanced competitiveness, reduced costs and wider product choice – all within a framework that provides appropriate protections to different classes of investors.

3. Progress Towards Implementation Prior To The Crisis

The EU-US Coalition on Financial Regulation (see Appendix 1), in its first Report “The Transatlantic Dialogue in Financial Services: A Case for Regulatory Simplification and Trading Efficiency (September 2005) and in its second Report “Mutual Recognition, Exemptive Relief and ‘Targeted’ Rules’ Standardisation: The Basis for Regulatory Modernisation” (March 2008) set out what it perceived to be the three “gateways” to modernising the regulation of what is an increasingly global business and reducing the complexity, cost and burden of complying with differentiated national rules whilst at the same time appropriately protecting different classes of investors; namely:

- (i) Exemptive relief, i.e. relief from compliance with host state rules in the case of foreign firms or issuers engaged in wholesale business or exchanges where the imposition of those rules would be unnecessarily duplicative or inappropriate, bearing in mind the nature of the counterparties and the business being undertaken;
- (ii) Regulatory recognition (which may be unilateral, bilateral or multilateral) i.e. acceptance by a host state regulatory authority of compliance by a foreign firm, issuer or exchange with its home country licensing, prudential and business conduct rules on the basis of shared regulatory policy, principles and outputs
- (iii) Rules’ standardisation, i.e. the development of common approaches, international standards and/or converged rules “targeted” to deliver simplified market/customer /provider access and incremental business efficiencies or where there is insufficient approximation in the output of rules to facilitate regulatory recognition;

This position was broadly accepted by regulators, and in 2007 in a seminal article in the Harvard International Law Journal, Ethiopis Tafara and Robert J. Peterson of the SEC set out some detailed thinking on how this agenda might be developed as part of a strategy for improving regulatory efficiency¹ under the designation "substituted compliance".

Progress was also made in a number of areas on developing mutual exemptive relief based on examination of other systems. The most notable of these was the *Mutual Recognition Arrangement between the United States Securities and Exchange Commission and the Australian Securities and Investments Commission* of August 2008², in which the SEC and ASIC agreed that there was sufficient commonality between their regulatory standards and approaches to grant exemptive relief in each jurisdiction to exchanges and broker-dealers

¹ Tafara and Preston, HILJ (2007) Vol 48 No 1 pp. 31-68

² http://www.sec.gov/about/offices/oia/oia_mutual_recognition/australia/framework_arrangement.pdf

seeking to do business in each other's countries. (It is believed that similar negotiations with Canada were being progressed prior to the onset of the financial crisis.)

II. IMPACT OF THE CRISIS ON REGULATORY RECOGNITION

1. Re-prioritisation of regulatory policy

In the aftermath of the crisis, the primary focus of regulatory policy around financial services switched abruptly – and correctly – away from regulatory recognition to the urgent need to address the lessons of the crisis. It was felt that one of these lessons was that a regulatory system which had been perceived to be robust and effective had turned out, under stress, to be sub-optimal in a number of areas. The primary objective was to address identified weaknesses by establishing a new set of more interventionist and intensive regulatory and prudential standards and processes to reduce the potential for firm failure, recapitalise risk, enhance governance and individual responsibility and generally make the marketplace more shockproof.

This reprioritisation of the objectives of regulation generated a change in focus from improving market efficiency to improving the protections offered to domestic consumers and enhancing the power of national regulators to control the activities of certain types of firms. The primary concerns were:

- (a) limiting the activity of institutions, based in their jurisdictions, particularly banks and other firms which posed the risk of public sector support in the event of default; and
- (b) enhancing host-state regulation of the activities of those firms doing business either cross-border or through branches based in their jurisdictions – a key lesson of the Icelandic collapse.

It is worth noting in this context that the absence of any effective global framework for addressing a global financial crisis meant that the immediate legislative and regulatory responses to the crisis were resolutely national or, at best, regional. Regulators and Governments in general did not act collectively to respond to the failures resulting from the crisis, but – driven by the need for urgent action – nationally, and only domestic legislation solutions could ensure that problems were rapidly addressed. Some administrations formed the view at an early stage that passing national legislation early could have the additional advantage of setting the international agenda, but this has not been borne out by experience. Some convergence in approaches was facilitated by the governing principles and standards for post-crisis regulatory repair set by the international standard-setting bodies, but national implementation has meant not just the emergence of a differently-paced timetable, but differences in the interpretation and implementation of those standards.

This national approach to regulatory repair has impacted on regulatory and supervisory authorities as governments have become more closely involved in setting their agendas and policy priorities. The crisis may have been global, but regulatory authorities are local and, understandably, are focussed primarily dealing with how the crisis has impacted firms and customers within their own domestic jurisdictions.

2. Consideration and rejection of "Balkanisation" as a regulatory response

If regulating international financial business is complex and difficult, it is reasonable at least to ask whether the problems thereby created might be solved by preventing the businesses involved from acting internationally in the first place. It is understandable that a regulator could be more confident of its control over financial activity in its jurisdiction if that jurisdiction had a rule that no overseas institution could do business within that jurisdiction, and firms within that jurisdiction could not do overseas business. The difficulty which this creates is that since the availability of credit and financial services is both an industry in itself and a source of economic growth, the effect of such a measure would be to (a) increase the cost of financial services in that jurisdiction because protectionism increases economic rents charged by the industries protected to the economy concerned; and (b) reduce the potential for economic growth. As a result, the "Balkanisation" approach to regulation amounts to a direct trade-off between regulatory certainty and economic growth.

These issues have been considered at the G20 level. Unsurprisingly, the G20 clearly rejects protectionism as damaging – the communiqué from the first G20 Leaders' Summit (November 14-15, 2008, Washington D.C) provided that:-

*We underscore the critical importance of rejecting protectionism and not turning inward in times of financial uncertainty. In this regard, within the next 12 months, we will refrain from raising new barriers to investment or to trade in goods and services, imposing new export restrictions, or implementing World Trade Organization (WTO) inconsistent measures to stimulate exports. Further, we shall strive to reach agreement this year on modalities that leads to a successful conclusion to the WTO's Doha Development Agenda with an ambitious and balanced outcome. We instruct our Trade Ministers to achieve this objective and stand ready to assist directly, as necessary. We also agree that our countries have the largest stake in the global trading system and therefore each must make the positive contributions necessary to achieve such an outcome.*³

This commitment was reaffirmed at the 5th Leaders Summit in Seoul, where it was said that

*Since 2008, a common view of the challenges of the world economy, the necessary responses and our determination to resist protectionism has enabled us to both address the root causes of the crisis and safeguard the recovery. We are agreed today to develop our common view to meet these new challenges and a path to strong, sustainable and balanced growth beyond the crisis.*⁴

However, the place where the interaction between financial regulation, protectionism and economic growth was most clearly addressed was at the Fourth (Toronto) Summit, where it was said in the main communiqué that

³ Point 13 - <http://www.g20.org/images/stories/docs/eng/washington.pdf>

⁴ Point 8 - <http://www.g20.org/images/stories/docs/eng/seoul.pdf>, November 11-12, 2010

3. Our efforts to date have borne good results. Unprecedented and globally coordinated fiscal and monetary stimulus is playing a major role in helping to restore private demand and lending. We are taking strong steps toward increasing the stability and strength of our financial systems. Significantly increased resources for international financial institutions are helping stabilise and address the impact of the crisis on the world's most vulnerable. Ongoing governance and management reforms, which must be completed, will also enhance the effectiveness and relevance of these institutions. We have successfully maintained our strong commitment to resist protectionism.

The Annexe to the Communiqué stated that

13. Across all G-20 members, we recognise that structural reforms can have a substantial impact on economic growth and global welfare. We will implement measures that will enhance the growth potential of our economies in a manner that pays particular attention to the most vulnerable. Reforms could support the broadly-shared expansion of demand if wages grow in line with productivity. It will be important to strike the right balance between policies that support greater market competition and economic growth and policies that preserve social safety nets consistent with national circumstances. Together these measures will also help unlock demand. These include:

- *[last bullet point] Actions to accelerate financial repair and reform. Weaknesses in financial sector regulation and supervision in advanced economies led to the recent crisis. We will implement the G-20 financial reform agenda and ensure a stronger financial system serves the needs of the real economy. While not at the centre of the crisis, financial sectors in some emerging economies need to be developed further so that they can provide the depth and breadth of services required to promote and sustain high rates of economic growth and development. It is important that financial reforms in advanced economies take into account any adverse effects on financial flows to emerging and developing economies. Vigilance is also needed to ensure open capital markets and avoid financial protectionism.⁵*

It is therefore clear that the protectionist approach to regulating international finance has been considered and rejected at G20 level.

It should also be noted in this context that the same position has been taken within the EU. The European Commission has frequently recognised the contribution of open rights of access and market liberalisation in driving early economic recovery, e.g.:

- In its October 2008 Communication "From financial crisis to recovery: A European framework for action", the Commission emphasised "the need to maintain the EU's

⁵ <http://www.g20.org/images/stories/docs/eng/toronto.pdf>, June 26-27, 2010

commitment to open markets in trade and services and deeper multilateral co-operation, fighting against protectionist tendencies and pursuing a positive outcome at the WTO Doha Round” (page 8)

- In its Communication “Driving economic recovery” (4th March 2009), the European Commission emphasised that *“protectionism and a retreat towards national markets can only lead to stagnation, a deeper and longer recession and lost prosperity”* (page 11) and that *“an equivocal message is essential to hold off these threats”* (i.e. *“domestic pressure to apply restrictive measures”*).
- In a recent speech, Commissioner Barnier said that *“We need an integrated market... not only within the EU, but worldwide”* and that in order to achieve this *“global business should be able to carry out their activities worldwide without too much regulatory overlap”*⁶

3. Enhanced awareness of the problems of recognition

It is also important to emphasise that the crisis provided many regulators with an object lesson in the potential harm which can arise from cross-border financial business if that business is not appropriately controlled and regulated. It is therefore unsurprising that in the “lessons learned” phase of analysis, thinking focussed on the detriment which can arise from cross-border business. This included in particular:

- (a) Vulnerability to global contagion. The rapidity with which US sub-prime losses cascaded through the financial system without regard to markets or national borders meant that the system did not contain sufficient fire-walls to deal with global risks and this, in turn, led to the perception that fire-walls built on national borders might be the solution.
- (b) Weaknesses in macro- supervision. The exposure of individual institutions to individual markets had been underestimated, in good part because of the interconnection mentioned above, but also because of weaknesses in governance and risk controls, and the lack of policy tools available for the purpose of delivering cross-border macro-economic restraint. Put simply, national regulators could only regulate their national institutions, but adverse economic developments – in particular the inflation of domestic credit bubbles – could not be restrained by regulating national banks, since it would simply be replaced by cross-border finance.
- (c) Different regulators had different regulatory priorities, and tended to allocate their capabilities and resources in accordance with those priorities. Thus, for example, some regulators regarded hedge funds as a major threat to the financial system, whereas others regarded them as neutral or benign factors in the regulatory landscape. The same was to some extent true of structured finance vehicles, which were frowned upon in some jurisdictions but permitted without limit in others.

⁶ Barnier, Eurofi High Level Seminar, Copenhagen, 29 March 2012

4. Enhanced awareness of the advantages of international co-operation

One of the most important lessons learned by the public sector arising out of the crisis was weakness in the supervision of the largest financial institutions. Regulators must be able to do two things; deploy their resources most efficiently as regards smaller entities, and maximise the effectiveness of the deployment of their resources as regards larger entities. It also became clear that regulators needed to change their approach to G-SIBs and G-SIFIs. Rather than considering themselves as responsible for supervising a discrete part of the relevant entity or group, they need to regard themselves as collectively responsible for supervising the entirety of the institution concerned.

A key difficulty arose in connection with the regulation of a large branch. Both home and host authorities have responsibilities, but no two branches are identical, and relatively minor differences in management structure, IT reporting systems or legal entity booking practices may have a major impact on the extent to which a problem with the branch could affect the entity as a whole or vice versa. Although legal systems will determine which institutions would be regulated by which regulators, in reality the only way in which regulators can deal with such situations is ad-hoc and co-operatively. However, since this approach is unlikely to be practical for any but the largest institutions, the question is therefore as to how to avoid damaging underlaps or resource-consuming overlaps in the regulation of cross-border activities.

The crisis therefore demonstrated the overwhelming importance of international co-ordination in the regulation of markets and institutions and the regulatory standards and principles set by international bodies. The primary drivers of this recognition were:

(a) The pre-eminent importance of more effective supervision of global entities

One of the more vital lessons from the crisis was the signal importance of those institutions characterised as "systemically important". It had been argued in some quarters that these institutions should absorb less regulatory effort as they were more stable, diversified and had better risk controls in place. In fact, this was not the case. They required enhanced degree of supervision because of their criticality to the global financial system as transmitters of stress through the system and because of their importance as sources of stability and liquidity to the system as a whole. The conventional approach to regulating these global organisations had, it was felt, been revealed as inadequate, and a significantly higher level of regulatory co-operation and interaction was essential to dealing with these entities.

(b) Growth in the regulatory and supervisory remit of regulatory authorities without a commensurate increase in resources

The importance of improving the efficiency of regulatory processes became a more important consideration than it was in the past. This applies across the functions of policy-making, rule-making, supervision and enforcement, but within the context of the continuing pressure – particularly in this climate – on all public sector bodies to improve their cost-efficiency.

- (c) The crisis did significant and lasting damage to the economies of the western world, and had a negative effect worldwide

Part of the response to this has been a focus by government on economic growth and business recovery, and in particular on repairing the global financial system in order to enable it to perform its core function of aggregating savings and using them to finance economic development. Regulation has a significant part to play in this repair process⁷.

The aggregation and investment functions of the financial services industry are most efficiently performed on a global basis, since at any given time certain economies will have excess savings and others will have requirements for capital. Thus in order to enable the financial system to operate as a catalyst for growth – a key priority in what is expected to be a protracted period of serious economic stress – it is necessary to enable financial business and the regulation of that business to operate internationally. It should be noted that this is not the sole preserve of international businesses – it is feasible for international financial services to be delivered through interlocking networks of national businesses, as was classically the case prior to the beginning of the last century. However, a system composed of interlocking private entities is arguably harder and more burdensome to regulate than a system composed of a smaller number of larger international entities, and it is certainly the case that the existence of the latter enables regulators and policymakers to take a more informed view of the state of the global financing process.

As a result, in order to deliver the priority objective of rendering the financial system better suited to its core economic function, regulators find themselves effectively obliged to create mechanisms for regulating cross-border businesses.

- (d) The importance of facilitating an efficient and competitive market in financial services (see also (e))

Savers, investors and risk managers need to be able to access the widest range of investment possibilities which is compatible with safety and to be able to manage their risks efficiently. Those raising capital should be able to access the largest possible pool of capital on the broadest possible sets of pricing and terms. The difficulty with a retreat behind national regulatory barriers is that it cuts off savers and investors from these sources. It may be argued that this is a national good in terms of utilising national savings to financially strengthen domestic economics and support national investment. However, the demand for investment is conditioned by the savings preferences, investment diversification and risk-management needs of savers. Facilitating the international needs of savers and investors and the coherent regulation of those cross-border businesses will more efficiently and effectively fulfil the economic objectives of governments, than a retreat into economic protectionism.

⁷ It is important to emphasise that the objective of this process is not to enable the growth of financial services sector businesses per se, but to enable those businesses to facilitate economic growth in the economy as a whole – there is no regulatory objective of maximising the profitability of the financial services industry

- (e) A key part of the post-crisis agenda has been the desire to concentrate dealings and the risk of dealings in financial instruments into centralised venues which are under the supervision and control of regulators

This applies in the context of trading, clearing and settlement, and trade reporting. One of the key drivers of this move towards centralisation is that where trades are concentrated and offset through central trading and clearing venues, liquidity, transparency and risk management are all likely to be optimised, but only within the context of regulatory recognition of market infrastructures to avoid the emergence of duplicative locally-licensed markets.

- (f) The drive to establish safer markets and to strengthen investor protection

Supervising a broader and deeper set of standards governing markets and protecting investors in the context of cross-border business comes at a high cost and can only really be fully achieved through close co-operation between regulatory authorities in order to even out standards in this area and reduce the high cost of regulatory differentiation.

As pointed out above, the failure to incorporate a practical framework for the regulatory recognition of foreign infrastructures will generate the establishment of a multiplicity of national trading, clearing and reporting venues. This would result in a significant increase in market fragmentation and also in terms of costs of supporting duplicative national infrastructures. In addition, it would enhance concentration risk, i.e. fewer clearing members supporting more infrastructures, reduce cost offsets, fragment liquidity and stability, and underpin the localisation of regulatory standards (which was arguably one of the problems that generated the crisis). The benefits of recognising foreign infrastructures are self-evident, but there are consequences. Firstly, regulators in jurisdictions which do not have their own market infrastructures will depend upon the sound operation and efficient regulation of centralised venues in other jurisdictions, and that will mean high levels of due diligence on oversight standards and detailed protocols with the regulators of those venues. Secondly, regulators of those venues which do exist within their jurisdictions must recognise that they are now regulating not only in their own national interest and in the interests of their own firms and customers, but in the collective interests of all those markets participants who will be heavily dependent on those venues. This will require a new approach to the regulation of market infrastructures, clearing and settlement and reporting venues.

III. Post-crisis Mutual Recognition

1. The present position and way forward

There is no doubt that, in the absence of a positive public policy push towards the adoption of a mutually co-operative approach to regulation of international firms, the trend will be towards the re-establishment of national jurisdictions acting as barriers to the conduct of cross-border business. This may be for anti-competitive reasons – such as a desire to protect domestic businesses, to exclude overseas competitors from domestic markets, or to mandate trading and clearing activity towards domestic service providers – or for practical regulatory reasons, such as a lack of resources to analyse complex conflicts of law and regulation. Even

where a regulator may be positively seeking to integrate its jurisdiction into the global financial markets, the problem will remain that, in the absence of a co-ordinated international initiative on these issues, the number of bilateral determinations that it is required to make may be far in excess of the resources available to it. Even between major, well-resourced regulators, problems may be allowed to fester for no reason other than lack of intellectual bandwidth. In order for regulators to enable their markets to be competitive and efficient, mutual recognition as a technique for mitigating unnecessary complexity and promoting the efficient use of regulatory resources is already important, and is likely to become essential as the burden of regulation on cross-border firms and regulators continues to increase.

US recognition of the EU regulatory framework may be better facilitated post-crisis (even though there may be continuing differences in legal systems and market practices) by the implementation of the European Market Infrastructure Regulation (EMIR), the Markets in Financial Instruments Directive (MiFID) and the Markets in Financial Instruments Regulation (MiFIR), provided that these regimes are not used to create unrealistic and impractical "equivalence" requirements for recognition of non-EU regimes. We are aware of widespread concern that some of the third-country elements of this proposed legislation could be interpreted and implemented in a way which could lead to regulatory protectionism. However, we hope that this will not be the case in practice. More positively, these new provisions will facilitate the harmonising of regulatory responsibilities and functionality through the oversight of the new European authorities (and they facilitate EU regulatory recognition) in terms of:

- establishing a programme for post-crisis EU regulatory repair and enhancement, which will, notwithstanding a number of key differences, be held substantially in common with the US;
- taken together with the new co-ordinating powers of ESMA, achieving the overarching objective of establishing a much more unifying single framework of rules across the EU; and
- taken together with the new powers given to ESMA, resulting in closer co-ordination and harmonisation as regards the supervisory and enforcement functions of individual EU competent authorities.

2. Extraterritoriality

Legislators sometimes, either deliberately or through inadvertence, create financial regulatory legislation which operates extraterritorially. It is generally not open to regulators to elect to ignore the legislation which they implement, even where their formal powers do not extend to those captured by the legislation. Consequently such legislation operates as a mandate to regulators to expend energy in areas which are unlikely to be productive.

The key message as regards extraterritoriality is that the optimum mechanism for legislators to establish extraterritorial regimes is through co-operation with other comparably-motivated legislators to establish and enforce global standards. However, where this approach is not taken, regulators can still address extraterritoriality, where it is properly justified, through regulatory co-operation rather than unilateral action.

An objection which may be raised to some of the foregoing is the suggestion that there is no harm in creating legislation which cannot be enforced in practice by the regulator charged with enforcing it because the legislation may have a deterrent effect in any event. There is some truth in this position, but it disregards a wider point. Regulators do not generally have the luxury of deciding to ignore parts of their statutory mandates. If a regulator is given a responsibility, it is under an obligation to supervise compliance and consider how and where to investigate and act in relation to breaches, and it must devote time and resource to that consideration and to implementing the resulting policy.

The financial crisis has forced national regulators to undertake reforms that are broader in scope than necessary or which are based on domestic concerns and to be less concerned over the impact on international financial markets. This can lead to regulation that is inappropriately extraterritorial in effect and which diverges between financial centres.

GFMA together with other trade bodies sent a letter (Appendix III) on extraterritoriality in advance of the G20 Finance Ministers meeting in Washington in April 2012. The letter and the annexes provide specific examples of legislation or regulation which illustrate the major concerns which affect members and their clients. The letter sets out six types of concerns:

1. Duplicative requirements;
2. Incompatible or conflicting requirements;
3. Distortion of competition/reduction of customer choice;
4. Unintended impact on clients / counterparties who are not directly subject to regulation;
5. Lack of process for mutual recognition or comparability; and
6. Regulatory uncertainty and disproportionate compliance burden

The letter highlights the concern that regulators have put too much emphasis on equivalence. It is a concern that unduly strict equivalence, particularly when applied to the rules as opposed to standards and outcomes, could be used as a vehicle for disguised protectionism, and this could do significant damage to an international financial system whose effective functioning is essential to establish a global economic recovery. Standards of comparability should be outcomes-based, and not used as a tool to export regulations from one jurisdiction to another. Policies that promote the concept of reciprocity may be equally dangerous and could cause a serious rift.

3. The international standard-setters

The primary responsibility for driving the policy and regulatory response to the crisis was initially assumed by the G20. It is important to emphasise that this was probably the most significant example of worldwide financial regulatory policy-making yet seen. It is abundantly clear to all governments that the correct approach should be co-ordinated internationally, reflecting the G20 priorities and facilitating regulatory coherence. The G20 programme has thus far been broadly adhered to by all of the major members of the G20, with the detailed work on regulatory policy making being undertaken through the newly-established Financial Stability Board, and also through the work of other supranational entities, including the Basel Committee on Banking Supervision and the International Monetary Fund.

Thus far, however, these bodies have not explicitly endorsed mutual recognition. This may seem surprising, in that attempts to harmonise global rules on a particular topic might

logically be expected to (a) cover the implementation and enforcement of those rules; (b) urge that observance of the global standards should provide the bedrock for recognition.

So far as (a) is concerned, the current consensus is that although the formulation of policy and rule drafting where appropriate should be international, supervision should remain national within as necessary, regional frameworks. There are a number of drivers for this. National governments, concerned about their potential exposure to bailed-out firms, feel that the conduct of supervision is their major defence against further default and additional public sector bailout. For this reason, it is not surprising that they wish to maintain tight controls in this area. National supervisory styles differ significantly, and it is not clear that harmonising different supervisory approaches would be productive in terms of achieving the overall end of regulation. Supervisory authority is vested in different types of organisations, and there is no clear argument for structural reform of supervisors at a stage when everything else is in flux. However, all of these arguments point to the inevitable conclusion that, whether or not supervisory harmonisation would be useful at this stage, the existing regulatory agenda is currently far too full to accommodate extraterritorial expansion in the application, supervision and enforcement of domestic rules – and this flows into (b) and the understanding of the need for recognition in order to reduce cost, complexity and duplication in the individual systems and processes of regulatory authorities.

IV. The Intellectual Architecture Of Regulatory Recognition Post-Crisis

Regulatory systems will always differ significantly from each other in the detail of their construction and the precise scope and extent of their rules. However they generally differ little – if at all – in the basic principles of their construction. In broad terms, all regulators needs to be generally satisfied with respect that a regulated firm

- (a) has fit and proper controllers and senior managers
- (b) has competent and experienced staff
- (c) has proper procedures in place to ensure compliance with, all applicable laws and regulations relating to its business
- (d) is financially sound and stable and is meeting all applicable liquidity and capital requirements
- (e) is able to and does provide appropriate levels of protection to customers
- (f) is able to ensure the maintenance of high standards of market and business conduct, including the management of conflicts of interests

In each of these cases, it is possible for a regulator to rely to some degree on the work of other regulators. This is the basis of the recognition approach.

1. Approaches to recognition

There are broadly three ways in which a regulatory authority can admit overseas firms to dealing in its territory or with its consumers.

1. A full "passporting" arrangement based on a finding that the applicable regulatory regime is broadly identical to that of the admitting state. In broad terms, where there is a finding of full equivalence of supervisory regimes there is generally no argument against granting effectively unlimited access, subject to an effective allocating of responsibilities as between home and host jurisdictions.
2. An admission regime based on an acceptance that regulatory systems, although different, have broadly similar outcomes. This is generally referred to as "mutual recognition" (but it can be unilateral), establishing that the entity is subject to functionally the same requirements as entities established in the relevant jurisdiction. Such findings are generally by definition bilateral. In practice such determinations are most efficiently performed by identifying independently determined descriptions of policy outcomes and assessing both systems to be compared against that yardstick.
3. Exemptive relief, which is generally used in circumstances where the disbenefit to the country concerned of obstructing access by its residents to certain non-domestic services and service providers is significant, and the threat posed is minimal. Exemptive relief is unilateral, and is generally provided only in limited contexts – usually bare service provision unaccompanied by marketing or directed selling efforts within the jurisdiction concerned. Thus, where institutional investors in Country A wish to invest in financial products traded in Country B, Country A may be prepared to grant exemptive relief to permit market infrastructures and investment firms in Country B to facilitate execution of orders without contravening its financial securities laws. Exemptive relief is based less on the an assessment of the securities laws of the other jurisdiction and more on the basis of the requirements and vulnerabilities of investors in the home jurisdiction and how close these are to the position of host state investor protections. In practice, though, the two are interlinked and it does often depend upon a due diligence assessment.

In general, equivalence, in its strictest interpretation, is an impossibly high standard to reach without a continuing programme of legislative harmonisation lasting many years. Equivalence clearly can be attained in some circumstances (and was broadly attained between the member states of the EU, but only after many years of legislative and regulatory convergence), but in general it is the result of an extended period of co-operative approximation of laws. It is therefore not a useful basis for the development of mutual recognition, unless it is tempered by a degree of regulatory pragmatism. In this regard, the recent statements by Commissioner Barnier⁸ to the effect that the EU may be prepared to interpret "equivalence" in a way which can be satisfied by "comparability" rather than strict equivalence is a welcome development.

2. Bases for mutual recognition

In general terms, a regulator will not authorise a firm to conduct regulated business until it is satisfied that it is fit and proper to conduct that business and capable of complying with its rules and requirements on an ongoing basis. To this end, it will supervise firms on a more intensive and interventionist basis to ensure that (a) firms have the resources, systems and arrangements in place to comply with regulatory requirements on an ongoing basis; and (b) firms' past behaviours have not involved regulatory breaches.

Regulators tend to be more concerned with the future than with the past; and, in the context of regulatory supervision of regulated firms, this concern manifests itself with a priority

⁸ <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/12/246&type=HTML>

concentration on governance, systems and controls for managing risks, compliance with prudential rules and observance of good business standards. International firms undertaking cross-border business make the regulator's job more difficult insofar as, although there will be local compliance departments in major offices, compliance, reporting and customer service systems will operate on an institution-wide basis and the overall approach of a firm to compliance is unlikely to be constructed along separate national lines. It should be noted that, since management and control systems rarely coincide with legal structures, this will usually be the case irrespective of whether local operations are conducted through branches or through subsidiaries.

These issues can to some extent be addressed through memoranda of understanding between national regulators. However this is by definition a partial solution – the FSA, for example, would be able to confirm to the SEC that it was satisfied with the compliance systems of a particular firm, but not whether those systems complied with the detail of the applicable US regulations.

3. Assessing whether the preconditions for mutual recognition are in place –shared regulatory objectives are central

As with any piece of legislation, compliance with regulatory provisions can be measured in one of two ways. One is comparing the rules themselves on a "line- by- line basis", to see whether they are comparable with each other. The other is to assess the objectives which the rules seek to achieve, and assessing whether these are comparable. When dealing with cross-border situations, the same can be applied to comparisons of different regulatory systems. On the one hand, systems can be compared line-by-line, and such comparison will generally conclude that they differ substantially. On the other, they can be compared in terms of the objectives which they are intended to deliver and outcomes that are achieved, and on this ground they will generally be found to differ little if at all.

How can regulatory systems be compared? Once it is accepted that a "substituted compliance" approach might be adopted, it immediately becomes clear that what is being compared are legislative and regulatory systems rather than individual provisions. Thus it should be possible for detailed comparisons to be drawn up between the systems of two countries with the aim of identifying the areas (if any) in which there is the potential for significant divergence between them in terms of outcomes. In this context it is essential to maintain a clear distinction between techniques and outcomes – divergent techniques are almost irrelevant for this purpose – the question is one of the extent to which the techniques may produce divergent outcomes. Thus, for example, the legal theories by which insider dealing is prohibited are very different between the US and Europe, but the outcomes are very similar.

In this context, it should be noted that a number of international bodies have done significant work identifying the key attributes of regulatory systems, and, in particular, the IOSCO *Objectives and Principles of Securities Regulation*⁹ Report. This illustrates that not only is there a great deal of commonality as to the principles of regulation, but also that the objectives of regulation can be achieved through a wide variety of different techniques. Regulation is broadly irrelevant without supervision and enforcement, and it is clear that an assessment of the outcomes of any particular regulatory system would necessarily involve an assessment of the effectiveness of the process by which compliance with the regulatory regime is policed and sanctioned. This is a difficult comparison. Supervisors and supervisory practices differ

⁹ International Organisation of Securities Commissions, May 2003

substantially between jurisdictions, and there is no clear basis for ranking different techniques in order of effectiveness. Consequently this assessment should also, to some extent, be outcomes-based. In this context the problem is likely to be more complicated, since a more active regulator is likely to have a stronger record of successful enforcement proceedings than a weak regulator, but this in turn will mean that there is more evidence of rule breaches in that regulator's jurisdiction – a phenomenon which can create the optical illusion that the stronger the regulator, the weaker the system. There are also differences of philosophy within the regulatory community between those who believe in on-site inspections and those who believe in intelligence-led theme-based investigations, such that individual regulatory practices are rarely strictly comparable between different national regulators.

In order to accept a substituted compliance approach, a regulator would therefore have to have made two determinations. One would be that the legal and regulatory system which applied to the firm concerned in the overseas jurisdiction was effective to produce outcomes which were closely aligned with those of the regulator's own jurisdiction. The other would be that the supervisory practices of the regulator in the jurisdiction concerned were sufficient to give it confidence that the firm was regularly and forcefully being held to account according to those requirements.

4. Prioritisation of regulatory overlaps

A well-known methodology for analysing the extent of regulatory interaction is to divide it into gaps, overlaps and conflicts. The argument is that gaps constitute severe threats which must be addressed immediately, since they may permit customers to be abused; conflicts constitute second order threats, since they may prohibit otherwise valuable activities; and overlaps, not giving rise to direct conflicts, can be tolerated. Although intellectually appealing, this is oversimplified and, we believe, increasingly inaccurate. Clearly regulatory gaps present the greatest threat. However regulatory overlaps are capable of consuming large amounts of time and resource from both regulators and regulated, and time consumed in pointless or duplicative activities is time not available to be devoted to more effective activities. All three generate needless legal risk and compliance complexity. In a number of areas the most effective way to identify and close gaps and remove conflicts may be to begin by reducing overlaps.

5. Threshold criteria for implementing post-crisis regulatory recognition; significance of lead supervisor approach in certain contexts

In the post-crisis environment, mutual recognition clearly has a significant part to play, but that part has yet to be fully designed. It is recognised that cross-border information-sharing and co-operation are critical to optimising regulatory effectiveness and cost-efficiency. However, in an environment where the primary focus of policymaking activity is the political emphasis on protecting domestic consumers and regulating domestic businesses, it is clear that cross-border businesses require both strong home state regulation and integrated supervision by multiple regulators. This is the goal which mutual recognition will need to achieve before it can be accepted as a part of the regulatory toolkit.

Clearly, the strength of regulatory inter-reliance across different jurisdictions will depend heavily on the sharing of common regulatory scope, policy objectives, regulatory outcomes and high-level standards in resources and skills. This may mean that, at the operational level, arrangements between US regulatory authorities and individual competent authorities, whether they are part of a federated network of authorities, or are single national authorities,

may have to be significantly differentiated. Indeed, if regulatory interdependence is to be achieved safely and confidently without any significant exacerbation of regulatory risk, this is arguably inevitable.

Regulatory recognition and any accompanying operational differentiation in the underlying arrangements must therefore satisfy certain stringent criteria before it can be credible, safe and acceptable to a regulatory authority. These are:

(a) No loss of regulatory efficiency and effectiveness

This means that the operation of the mutual recognition measure must enable the recognising regulator to be as confident as it was before the measure was implemented of the quality of the firm's performance of its regulatory obligations for a commitment of no more resource. This will mean in practice, that the authority concerned must be satisfied that the firm concerned is subject to effective supervision and enforcement in its home jurisdiction.

(b) Shared standards and policy outcomes

The basis of recognition must be founded on common policy objectives, shared standards and comparable outcomes. This is in practice an equivalence test based on the outcomes delivered by the relevant system rather than the structure of that system – no two financial regulatory systems are identical, and few are sufficiently similar to enable line-by-line comparison. There are clearly minimum standards which should be required in specific areas, and we have set these out below, reflecting the basic principles discussed at the outset of this section of this paper; i.e.

- i. fitness and properness of controllers and senior management
- ii. competence of staff
- iii. awareness of, and proper procedures to ensure compliance with, all applicable laws and regulations relating to its business
- iv. financial soundness and stability, including liquidity and capital requirements
- v. ability to provide appropriate levels of protections to customers
- vi. ability to ensure the maintenance of high standards of market conduct, including management of conflicts of interests

While it is not clear how the European Commission will interpret “equivalence” for the purpose of regulatory recognition (but see page 18) and there are concerns over the proposed condition to recognition of “reciprocity”, it is notable that the above areas are similar to those identified by the European Commission in Art 37 of the draft of the Markets in Financial Instruments Regulation¹⁰

¹⁰ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0652:FIN:EN:PDF>

(c) Reduction in regulatory conflict and duplication in processes and resources.

Regulatory conflict arises where rules require firms to do different – and potentially conflicting – things in pursuit of the same regulatory objective. The elimination of regulatory conflict is generally a positive gain for both regulator and regulated provided that the regulatory objectives for the firm concerned remain unaffected. Duplication of process and resources arises where two regulators supervise the same processes within a firm, and again, its elimination is usually a net benefit for both regulator and regulated. In order to be satisfied that this process is in effect, it will be necessary for the relevant regulators to be satisfied that arrangements are in place between them to ensure that information can be exchanged on a comprehensive and timely basis. This should include at a minimum

- i. information concerning breaches by the firm concerned of the regulatory regime applied to it in its home jurisdiction, and
- ii. information concerning the process of supervision, and in particular the outcomes of supervisory inspections and other supervisory activities by the home regulator

The sharing of information between regulators is a complex area, since individual rights (ranging from data protection to litigation privilege), public law obligations and regulatory policy issues may all impinge on the ability of the home regulator to share information with host regulators and vice versa. It is therefore very unlikely that information sharing arrangements between regulators can be as simple as a commitment to disclose everything that is asked for. It is therefore necessary for regulators to accept that the requirement is for them to be satisfied that they have access to sufficient information to perform their functions.

(d) Avoidance of duplicative infrastructures and service provision

Regulators are generally required to maintain structures, systems and processes for ensuring that regulated firms perform their regulatory obligations, but a number of those processes, e.g. trade reporting and regulatory reporting systems, could be more cost-efficiently fulfilled through better interconnection between regulatory authorities to the point where that information can be shared by them, rather than firms being faced with multiple-reporting obligations. Again, this goes to the issue of sharing of information between regulators, and may be subject to the constraints identified above.

(e) Pooling the cost of more enhanced supervision, particularly in relation to cross-border business

Regulators in general accept that in the post-crisis world, at least some firms should be subject to more intrusive supervision. However more intrusive supervision requires a greater commitment of regulatory resource and, in particular, supervision of aspects of a firm's activities outside the home country of the supervisor concerned is significantly

more demanding in terms of time and resources. This means that regulators should, subject to exacting due-diligence assessment as to resources and capability and legal competence, positively seek out opportunities to rely on each other's supervisory work in a cross-border context in order to optimise regulatory efficiency and effectiveness.

(f) More efficient use of information

All regulators analyse the information which they receive from regulated firms. However different regulators have different priorities in terms of what they are seeking, and certain regulators may be centres of processing excellence in analysing particular types of data. Regulators should be prepared to rely on each other in order to optimise the processing of regulatory information.

(g) Avoidance of conflict of law problems for supervisors, firms and customers in determining which rules apply as a result of reduced rules' duplication and extra-territorial application

This is a major issue of legal uncertainty, not just for firms and their customers, but also for supervisors in determining which rules apply to what categories of business. While it is important for policymakers and regulators to satisfy themselves that their regulatory frameworks cover at least all of the business done within their jurisdiction, this necessarily and inevitably leads to regulatory overlaps. The consequential compliance complexity and legal risk can be reduced significantly through the disapplication of duplicative rules (essentially host-state rules) and enhanced international co-operation. This will also enhance the understanding of clients and avoid the uncertainty generated by determination as to which of several possible regulatory regimes/rules apply to any particular product or service.

The primary problem caused by regulatory overlaps is the necessity for regulators and firms to spend time analysing the precise territorial scope of different regulations. This difficulty also however extends to clients, who are generally unimpressed by uncertainty as to which of several possible regulatory regimes applies to any particular service.

Where overlaps occur between two regulatory systems both of which appear to be robust and properly implemented, there is no reason why these issues – and the accompanying costs – should not be eliminated through the negotiation of a clear and transparent mutual recognition protocol to govern the activities in question. This simple step could reduce costs for regulators, clients and firms.

(h) Avoidance of the problems of cross-border enforcement

Cross-border enforcement may arise either as a result of overlapping regulatory jurisdictions, or in the context of regulatory failures which affect clients in multiple countries or which are perpetrated by parts of the regulated entity which are located in multiple countries. In general there is little or no scope for mutual recognition as regards enforcement *per se*. However, the process of dealing with the firm concerned, seeking and managing discovery, negotiating settlement and if necessary conducting

tribunal or court proceedings are all areas where a collective approach based on a lead supervisor approach could deliver many of the same benefits that formal mutual recognition delivers in other context.

6. Further areas where mutual recognition could provide benefits

There are a large number of areas where these tests could be satisfied by effective mutual recognition regimes. Many of these are well-known, and arise in the mainstream areas of authorisation and conduct of business regulation. However, there are other areas in which a mutual recognition approach might be beneficial, e.g.:

(a) Regulatory reporting

Mutual Recognition can be implemented both directly and indirectly. There are many circumstances where a regulated firm is required to obtain regulatory confirmations from other firms, and these frequently give rise to inefficiencies where the two firms are in different jurisdictions. An illustration of this is that CFTC rules require DCO members that are not subject to CFTC oversight to report to the CFTC on their risk management rules or procedures. However such entities are almost certainly regulated in their home jurisdiction, and as a result (at least in the EU) will be required to report such information to their home regulator. The result of this process is to double the regulatory resources required to police this aspect of the firm's business for no discernible benefit. Similar issues arise as regards reporting transactions to data repositories – multiple reporting requirements to imperfectly connected databases can only have a destabilising effect on the overall reliability of those databases.

(b) Clearing requirements

One of the most significant examples of inefficiency arising from conflicting regulatory policies appears in the context of mandatory clearing requirements. For example, assuming that there is comparability in determining the eligibility of derivatives to be centrally cleared, US law may require that a derivative transaction between a US and an EU person should be cleared through a US clearing house, whereas EU law may require the same derivative to be cleared through an EU clearing house. Recognition will facilitate the policy objectives of both systems insofar as a derivative deemed eligible for clearing may then be cleared in either system. Another clearing-related problem arises in connection with the CFTC requirement that US customer dealings on a foreign clearing house must be cleared by a US-regulated entity. Recognition based on appropriate due diligence would avoid that unnecessary duplication and mitigate the risk of a “tit for tat” approach.

(c) Macro-prudential regulation

The case of macroprudential regulation highlights the necessity for co-ordination even in domestic regulatory issues. Macro-prudential regulation is, by definition, concerned with a particular economy. Like monetary policy, its focus is necessarily on the financial system to which it relates. However macroprudential policy is likely to be implemented in practice by the issuance of rulings to firms as to the terms on which they do certain

types of business (for example, restrictions on loan-to-value ratios for Mortgage lending) and possibly complete prohibitions on other types of business. Given that money is one of the easiest things to pass across borders, such regimes will necessarily try to be effects-based rather than location-based. A mechanism for achieving this aim as regards bank finance is set out in Basel III, where the proposed countercyclical capital buffer provides a mechanism whereby bank regulators in jurisdiction A can require bank regulators in Jurisdiction B to impose capital penalties on banks which lend into jurisdiction A, thereby inflating credit.

(d) Deposit insurance/resolution

One of the most important areas for the development of international co-ordination is the resolution of failing international investment firms and banks. There is no immediate prospect of a concluded global agreement in this area, and resolution authorities will be required to create between themselves protocols for dealing with failing firms. It is clear that the resolution of an international financial firm would require co-operation between the resolution authorities of at least the major jurisdictions in which the firm operated. This in turn would necessitate those authorities having both the appropriate statutory powers to intervene in this way, and the appropriate mandate to exercise those powers in support of a collective action being taken by the institution's resolution authorities rather than with the sole aim of maximising returns to domestic creditors.

(e) Group structural regulation

There is currently a vogue amongst legislators for mandating internal structural restrictions within groups – the Volcker rule, the Lincoln amendment and the Vickers proposals in the UK are examples of this. Clearly such regulations are motivated primarily through a desire to reduce the overall level of risk to which the institution concerned is subject and to enhance resolvability of that institution (with the attendant risk of public sector support) if it becomes insolvent. The concerns arise where governments seek to cancel out the competitive disadvantage which such rules may impose on their domestic firms by applying these rules to overseas institutions which may operate in their markets. In addition to being intellectually incoherent, regulation of this kind place great strains on regulators, since they in principle require regulators to police the global activities of the overseas firm concerned. To ask a US supervisor to police the activities of a Canadian Bank in London is, regardless of its other failings, a gross waste of regulatory resources.

7. The IOSCO Principles of Securities Regulation (2010)

In 1998, IOSCO published its report “Objectives and Principles of Securities Regulation” which established thirty principles of securities regulation – principles which, in general, are relevant to other forms of financial services and market activity – with the specific purpose of fulfilling the three core objectives of (i) protecting investors; (ii) ensuring market integrity and transparency; and (iii) reducing systemic risk.

In its Introduction to the Principles, IOSCO stated: *“An increasingly global marketplace also brings with it the increasing interdependence of regulators. There must be strong links between regulators and a capacity to give effect to those links. Regulators must also have confidence in one another. The development of these linkages and this confidence will be assisted by the development of a common set of guiding principles and shared regulatory objectives.”*

These principles have been updated, in the current edition (June 2010), which carries through the architecture for co-operation provided by the original principles. The Coalition believes that these (now) thirty-eight IOSCO Principles (see Appendix 2) could provide a sound basis for measuring rules’ outputs and establishing a common set of regulatory values sufficient to deliver regulatory recognition for the following reasons:

- the three IOSCO objectives listed in para 4.8 are in accord with the objectives of most well-regulated jurisdictions (irrespective of whether or not their regulatory authorities are members of IOSCO);
- the eight categories of Principles (summarised in Appendix 2) emphasise the importance of high standards of regulation in terms of fairness, accountability, resources, enforcement, information-sharing and cooperative arrangements; set out the duties and obligations of issuers; set out the business conduct priorities and standards expected of intermediaries; and address the need for exchanges to maintain high standards in terms of transparency, market integrity and monitoring, managing and supervising market activities;
- the members of IOSCO, which, between them, are responsible for the regulation of over 100 jurisdictions and 90% of the world’s securities and other financial markets, have already endorsed these Principles;
- through their endorsement of the IOSCO Principles, the members of IOSCO have committed to use “their best endeavours” to ensure compliance with them and, while it is recognised that they will have to apply within their overall (and often differentiated) domestic legal and market frameworks, the members subscribe to the statement that “to the extent that current legislation, policy or regulatory arrangements may impede adherence to these principles, they intend that changes should be sought”;
- the intensive programme of assessing compliance with the principles carried out by IOSCO and the IMF since 1998 has shown high levels of compliance by members of the EU/EEA and Switzerland (all but a handful of which have been assessed) as demonstrated by the published assessment for each jurisdiction and the 2007 IMF Working Paper¹¹. It appears likely that completion of the EU’s FSAP programme will have contributed to enhanced compliance in some Member States, thereby pulling up the average. Testing of this should be relatively straightforward;

¹¹ IMF Working Paper: Strengths and Weaknesses in Securities Market Regulation: a Global Analysis; Ana Carvajal and Jennifer Elliott, October 2007

- by using IOSCO’s globally-accepted Principles, the European and US authorities would be basing their framework of regulatory recognition on a set of internationally accepted criteria for measuring the regulatory quality and, by adopting a more global and inclusive approach to recognition, would enable other jurisdictions to negotiate recognition on a similar basis.

The Coalition strongly supports adherence by regulatory authorities to the IOSCO Principles and believes that this is a critical step to modernising the regulation of cross-border financial services activities and meeting the commercial objectives of delivering a more open transatlantic marketplace. However, the Coalition is also conscious of the view that using the Principles alone as a sufficient means of measurement may not be sufficient – and reference is often made to the concept of “IOSCO+” (e.g. the need for rules and regulations to be transparent, accessible, intelligible and market flexible). Nevertheless, they are the most internationally accepted test of regulatory adequacy.

CONCLUSION

In the circumstances, the Coalition associations would urge the regulatory authorities on both sides of the Atlantic to come together with a view to resuming the pre-crisis negotiations on regulatory recognition or, as it has been otherwise described, “substituted compliance” in order to enhance the regulation of cross-border business and reduce jurisdictional conflict, legal risk and compliance complexity. In this context, the Coalition associations would suggest consideration be given to the following steps:

1. The establishment of a dedicated Working Group drawn from the key regulatory authorities on both sides of the Atlantic with the objectives of:
 - (a) in the short term, establishing the criteria for transatlantic regulatory recognition based on (i) compliance with the IOSCO Principles and Objectives for Securities Regulation; and (ii) accepted levels of compatibility in the areas of supervision and enforcement; and (iii) reviewing existing memorandum of understanding to ensure that they facilitate comprehensive and timely information-sharing and cooperation in the areas of supervision, investigation, and enforcement;
 - (b) in the longer term, undertaking a regulatory gap analysis to determine how fundamental differences in regulatory approaches can be converged or reconciled in such a way as to facilitate common standards and common approaches;
 - (c) establishing specific work processes and procedures to give practical effect to inter-regulatory memoranda of understanding and ensure that there are effective and credible operational outcomes;
 - (d) establishing a process whereby new regulations which have potentially extra-territorial effect are a departure from the basis of regulatory recognition are the subject of inter-regulatory consultations prior to their introduction (other than in cases of extreme market stress or urgency).
2. The establishment of an Advisory Group comprising investment banks, non-bank broker dealers, market infrastructures, including clearing houses and corporate and institutional

end-users of the markets to work with the regulatory authorities in identifying areas of regulatory conflict which impose significant burdens on both industry and regulatory authorities.

The Coalition associations believe that these are the kind of steps which need to be taken in order to give practical effect to growing awareness of the importance, in Europe, of regulatory recognition and, in the US, of “substituted compliance”.

**EU-US Coalition on Financial Regulation
Background Briefing Note**

EU-US COALITION ON FINANCIAL REGULATION: BACKGROUND BRIEFING NOTE

Who comprises the Coalition?

In early 2005, a group of leading EU and US financial service industry associations agreed to work together to address the urgent need to simplify the regulation of wholesale Transatlantic financial services business; and subsequently agreed to form themselves into the EU/US Coalition on Financial Regulation. They comprise, currently:

ABA Securities Association (ABASA)
Association of Financial Markets in Europe (AFME)
Bankers' Association for Finance and Trade (BAFT)
British Bankers Association (BBA)
Futures Industry Association (FIA)
Futures and Options Association (FOA)
International Capital Market Association (ICMA)
Investment Industry Association of Canada (IIAC)
International Swaps and Derivatives Association (ISDA)
Securities Industry and Financial Markets Association (SIFMA)
Swiss Bankers Association (SBA)

European Banking Federation (EBF) [*observer*]

Their objective, in coming together, was not to undermine acceptable standards of market integrity or investor protection but to increase the efficiency and coherence of applicable regulation and rules, which, despite the common standards and principles developed by IOSCO, continue to be geographically based and governed by differentiated national laws. The result is a complex and costly meld of regulatory duplication and conflict which sits uneasily with the increasingly global nature of financial markets and services, undermines the intended benefits of harmonisation, creates unnecessary customer confusion and imposes needless trading, investment and business costs and access restrictions on both the providers and consumers of financial services. The establishment of a more coherently regulated and open transatlantic financial services marketplace will enhance efficiency, access and competitiveness, bringing lower costs for institutional and other customers of the financial services industry and greater coherence in appropriate customer protections.

What are the objects of the Coalition?

The objectives of the Coalition are:

- (a) to encourage and expedite wider acceptance of *regulatory recognition* (whether unilateral, bilateral or multilateral) as accepted international practice;
- (b) to support the case for *exemptive relief* for defined levels of wholesale business;
- (c) to identify and promote the need for "*targeted*" *rules' convergence* where there is either (i) insufficient approximation in rules' outputs to facilitate recognition; or (ii) where convergence would deliver tangible benefits for the providers and consumers of financial services in terms of increased business efficiency, cost effectiveness, improved customer understanding or simplified market access.

The Coalition believes that, if the transatlantic regulatory dialogue is to fulfil its commercial as well as its regulatory objectives, the following factors should be taken into account:

- avoidance of regulatory “harmonisation for harmonisation’s sake” insofar as this would impose needless regulatory change and cost for thousands of smaller-sized EU and US firms that do not carry on transatlantic business;
- the desirability of establishing:
 - o a set of consensual regulatory standards/outcomes, which could facilitate, where appropriate, the continuance of acceptable rules’ differences;
 - o consensual “Principles for Better Regulation”, coupled with co-operative procedures for the forward development of rules;
- the need to secure regular and on-going industry and “stakeholder” input – recognising that financial service suppliers, infrastructure providers and consumers are best placed to identify commercial and market needs.

The first report of the Coalition

On 8th September 2005, the Coalition launched a major two-volume study “The Transatlantic dialogue in financial services: The case for regulatory simplification and trading efficiency¹²” in London and Washington. The Report highlighted areas of often needless regulatory duplication and conflict – needless largely because the rules were designed to achieve the same objective, yet their differentiation served only to complicate the process of compliance and increase cost for firms and their customers. The Report focussed on licensing and business conduct rules and was issued in two separate parts:

- A “*legal analysis*” which compared relevant US legislative requirements (including applicable rules of the SEC and CFTC) with EU directives (including CESR business conduct principles and the implementing rules of four specimen member states, France, German, Spain and the UK), since supplemented by a regulatory analysis of Swiss rules.
- A “*business case*”, which identified priority areas for regulatory change which would (a) simplify, without any diminution in standards of market integrity or investor protection, the framework of regulation for the carrying on of Transatlantic financial services business; and (b) play a significant role in achieving the objectives of enhanced efficiency and reduced trading costs.

More particularly, the Report argued for the formulation of a common set of customer definitions for the purposes of classification, solicitation and documentation; a common approach to core investor protection objectives such as “know your customer”; the development of a common set of examination and registration requirements; a consensual regulatory approach to other firms’ outsourcing arrangements; and the development of a forward programme to simplify critical areas of regulation such as the obligation to deliver best execution, trade allocation procedures, distribution of research, etc. The Report also urged that the process of rules’ development should

¹² Copies of the study are available from the Secretariat to the Coalition which is based at the FOA, 2nd Floor, 36-38 Botolph Lane, London EC3R 8DE or may be downloaded from any of the websites of the Participating Associations.

be underpinned by an agreed set of consensual principles of good regulation and a common approach to regulatory impact assessments.

The second report of the Coalition

The Coalition, noting the positive reaction to its 2005 report and the increased prioritisation that was being given to financial services regulatory recognition, issued a second report on 1st April 2008, *“Mutual Recognition, Exemptive Relief and “targeted” Rules’ Standardisation: The Basis for Regulatory Modernisation”*¹³.

This Report:

- (a) re-emphasised the importance of the three “gateways” to modernising the regulation of global business, i.e. *regulatory recognition, exemptive relief and targeted rules’ convergence*.
- (b) set out the key criteria for establishing a durable basis for regulatory recognition; and
- (c) identified industry priorities for “targeted” rules’ convergence;
- (d) reinforced the benefit of a more open and efficiently regulated transatlantic market place for all its “stakeholders”, including the regulatory authorities;
- (e) supported recognition/relief being afforded to foreign market infrastructure providers.

What is the next step of the Coalition?

The emergence of the financial crisis meant that the 2008 priority of developing a more efficient and open transatlantic market became subordinated to the priority objectives of implementing changes to regulatory structures, rules and practices in response to the lessons of the financial crisis.

In the view of the Coalition, however, early post-crisis economic recovery will be dependent in large part on establishing coherently-regulated and more open markets. This means that, allowing for other priorities and pressures on existing resources, the transatlantic dialogue in financial markets and services should be resumed as soon as possible – a view that was very much the position of the Coalition when it submitted its response to the post-crisis “Call for Evidence on Mutual Recognition of Non-EU Jurisdictions” (CESR/09-4060b), issued by the Committee of European Securities Regulators (CESR) in September 2009.

As a result, the Coalition – reflecting the growing governmental and regulatory focus on foreign regulatory recognition or accreditation – has commissioned the international law firm Clifford Chance to produce the report to which this briefing note is an appendix on the post-crisis benefits of regulatory recognition not just for the providers and consumers of financial services, but the regulatory authorities themselves.

In the circumstances, the Coalition associations would urge the regulatory authorities on both sides of the Atlantic to come together with a view to resuming the pre-crisis negotiations on regulatory recognition or, as it has been otherwise described, “substituted compliance” in order to enhance the regulation of cross-border business and reduce jurisdictional conflict, legal risk and compliance

¹³ <http://www.foa.co.uk/publications/eu-us%20report-%20mar08.pdf>

complexity. In this context, the Coalition associations would suggest consideration be given to the following steps:

3. The establishment of a dedicated Working Group drawn from the key regulatory authorities on both sides of the Atlantic with the objectives of:
 - (a) in the short term, establishing the criteria for transatlantic regulatory recognition based on (i) compliance with the IOSCO Principles and Objectives for Securities Regulation; and (ii) acceptable levels of compatibility in the areas of supervision and enforcement; and reviewing existing memorandum of understanding to ensure that they facilitate comprehensive and timely information-sharing and cooperation in the areas of supervision, investigation, and enforcement;
 - (b) in the longer term, undertaking the regulatory gap analysis to determine how fundamental differences in regulatory approaches can be converged or reconciled in such a way as to facilitate common standards and common approaches;
 - (c) establishing specific work processes and procedures to give practical effect to inter-regulatory memoranda of understanding and ensure that there are effective and credible operational outcomes;
 - (d) establishing a process whereby new regulations which have potentially extra-territorial effect or are a departure from the basis of recognition are the subject of inter-regulatory consultations prior to their introduction (other than in cases of extreme market stress or urgency).

2. The establishment of a Working Group comprising investment banks, non-bank broker dealers, market infrastructures, including clearing houses and corporate and institutional end-users of the markets to work with the regulatory authorities in identifying areas of regulatory conflict which impose significant burdens on both industry and regulatory authorities.

The Coalition believe that the steps indicated above would start the process of giving practical effect to the increasing acknowledgement being given to the importance, in Europe, of regulatory recognition and, in the US, of “substituted compliance.”

Objectives and Principles of Securities Regulation (2010)

PRINCIPLES RELATING TO THE REGULATOR

- 1 The responsibilities of the Regulator should be clear and objectively stated.
- 2 The Regulator should be operationally independent and accountable in the exercise of its functions and powers.
- 3 The Regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.
- 4 The Regulator should adopt clear and consistent regulatory processes.
- 5 The staff of the Regulator should observe the highest professional standards, including appropriate standards of confidentiality.
- 6 The Regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate.
- 7 The Regulator should have or contribute to a process to review the perimeter of regulation regularly.
- 8 The Regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed.

A. Principles for Self-Regulation

- 9 Where the regulatory system makes use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, such SROs should be subject to the oversight of the Regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.

B. Principles for the Enforcement of Securities Regulation

- 10 The Regulator should have comprehensive inspection, investigation and surveillance powers.
- 11 The Regulator should have comprehensive enforcement powers.
- 12 The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.

C. Principles for Cooperation in Regulation

- 13 The Regulator should have authority to share both public and non-public information with domestic and foreign counterparts.
- 14 Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.

- 15 The regulatory system should allow for assistance to be provided to foreign Regulators who need to make inquiries in the discharge of their functions and exercise of their powers.

D. Principles for Issuers

- 16 There should be full, accurate and timely disclosure of financial results, risk and other information which is material to investors' decisions.
- 17 Holders of securities in a company should be treated in a fair and equitable manner.
- 18 Accounting standards used by issuers to prepare financial statements should be of a high and internationally acceptable quality.

E. Principles for Auditors, Credit Ratings Agencies, and other information service providers

- 19 Auditors should be subject to adequate levels of oversight.
- 20 Auditors should be independent of the issuing entity that they audit.
- 21 Audit standards should be of a high and internationally acceptable quality.
- 22 Credit rating agencies should be subject to adequate levels of oversight. The regulatory system should ensure that credit rating agencies whose ratings are used for regulatory purposes are subject to registration and ongoing supervision.
- 23 Other entities that offer investors analytical or evaluative services should be subject to oversight and regulation appropriate to the impact their activities have on the market or the degree to which the regulatory system relies on them.

F. Principles for Collective Investment Schemes

- 24 The regulatory system should set standards for the eligibility, governance, organization and operational conduct of those who wish to market or operate a collective investment scheme.
- 25 The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.
- 26 Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.
- 27 Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.
- 28 Regulation should ensure that hedge funds and/or hedge funds managers/advisers are subject to appropriate oversight.

G. Principles for Market Intermediaries

- 29 Regulation should provide for minimum entry standards for market intermediaries.
- 30 There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.

- 31 Market intermediaries should be required to establish an internal function that delivers compliance with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters.
- 32 There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.

H. Principles for Secondary Markets

- 33 The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.
- 34 There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.
- 35 Regulation should promote transparency of trading.
- 36 Regulation should be designed to detect and deter manipulation and other unfair trading practices.
- 37 Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.
- 38 Securities settlement systems and central counterparties should be subject to regulatory and supervisory requirements that are designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.

**Joint association letter from GFMA, IBFED and ISDA identifying issues
relating to the regulation of cross-border business**



THE FINANCIAL SERVICES ROUNDTABLE 
Financing America's Economy

19 April 2012

The Honourable Timothy F. Geithner
Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Commissioner Michel Barnier
EU Commissioner for Internal Markets and
Services
European Commission
B-1049 Brussels

RE: Extraterritorial legislation: the problems posed for markets, clients and regulators

Dear Secretary Geithner and Commissioner Barnier:

As you and your colleagues prepare to meet at the upcoming G20 Finance Ministers meeting in Washington, we now write to follow up on the 17 February letter submitted by the Global Financial Markets Association (GFMA) raising concerns about regulatory reforms that may be creating conditions resulting in a fragmented transatlantic capital market. In that letter we referenced more detailed work we were undertaking to provide specific examples as to the extent to which a range of extraterritorial regulatory provisions are giving rise to difficulties in both interpretation and practice. A copy of this paper is attached in Annex 2 and 3.

In this paper, GFMA, The Financial Services Roundtable, the International Banking Federation (IBFed), and the International Swaps and Derivatives Association (ISDA) (collectively, the "Associations")¹ have set out six types of concerns:

1. Duplicative requirements;
2. Incompatible or conflicting requirements;
3. Distortion of competition/reduction of customer choice;
4. Unintended impact on clients / counterparties who are not directly subject to regulation;
5. Lack of process for mutual recognition or comparability; and
6. Regulatory uncertainty and disproportionate compliance burden

¹ A description of the Associations is set forth in Annex 1 to this letter.

Some of the most problematic instances of extraterritorial legislation for our members include:

1. Provisions of Dodd-Frank, including: the Volcker rule and the registration requirements for non-U.S. swap dealers and major swap participants;
2. Foreign Account Tax Compliance Act (FATCA);
3. Markets in Financial Instruments Directive (MIFID); and
4. European Market Infrastructure Regulation (EMIR)

While we welcome the ongoing discussions among U.S. and EU finance officials and relevant regulators to coordinate their respective regulatory reforms, a strong concern continues to be the emphasis on equivalency. We believe that standards of comparability should be outcomes based, and not used as a tool to export regulations from one jurisdiction to another. Similarly, we believe that policies that promote the concept of reciprocity may be equally dangerous and could cause a serious rift. Instead, in addition to conducting a global market impact assessment, we encourage the use of three “gateways” for modernizing the regulation of global business – mutual recognition, exemptive relief, and targeted rules convergence – in solving the difficulties to which extraterritorial measures give rise. Given our concerns, we are participating in the parallel follow-up work being taken forward by the EU-U.S. Coalition² on these issues. Further to this, we have attempted to outline practical solutions as described below:

1. Global Impact Assessment: It is essential that domestic and international regulators build into their impact assessment of proposed regulatory measures an analysis of the *overall* impact that relevant measures will have on markets globally. As part of this it is important to determine what policy makers are seeking to achieve and why extraterritorial measures may be thought to be necessary to meet these objectives. This would provide the opportunity to establish whether there are alternative means to secure these objectives that are less disruptive to firms and their clients. On occasion, unintended – and sometimes damaging – extraterritorial effects will arise simply from a

² In early 2005, a group of leading EU and U.S. financial service industry associations agreed to work together to address the urgent need to simplify the regulation of wholesale Transatlantic financial services business; and subsequently agreed to form themselves into the EU/US Coalition on Financial Regulation. They comprise, currently: American Bankers Association Securities Association (ABASA), Association for Financial Markets in Europe (AFME), Bankers' Association for Finance and Trade (BAFT), British Bankers' Association (BBA), Futures Industry Association (FIA), Futures and Options Association (FOA), International Capital Market Association (ICMA), Investment Industry Association of Canada (IIAC), International Swaps and Derivatives Association (ISDA), Securities Industry and Financial Markets Association (SIFMA), Swiss Bankers Association (SBA) and Observer: European Banking Federation (EBF). The group submitted the following letter: <http://www.sifma.org/uploadedfiles/newsroom/2008/us-eucoalition-fin-regualtion-reportmar08.pdf> (March 2008)

failure to consider wider consequences and possible alternatives: this can, we believe, be addressed by the development of a common approach to impact assessment that includes consideration of such potential effects. However, this procedure would not deal in itself with the instances where extraterritorial measures are consciously intended, and that we address in Annex 2 and 3 of this letter.

2. Mutual Recognition and Exemptive Relief: Common regulatory standards should be measured against equality of outcomes and effects, and not against the agreement of identical legal text. Recognising that complete and precise commonality of detail is likely to be elusive, mutual recognition – or exemptive relief for certain activities – would usefully extend the effect of broadly comparable standards. In addition, establishing and enhancing dialogue between regulators together with peer review processes would ensure that there is a commonality of standards, and a good understanding of priorities, so that mutual recognition would be developed on sound foundations of trust and shared interest.
3. Targeted Rules Convergence: Our view is that the G20 process, which can assist rules convergence as well as mutual recognition, should address the need for common regulatory standards to be developed. The Financial Stability Board (FSB) is well placed to take a leadership role in providing guidance as to where it is critical to have consistent implementation and where the detail of that implementation is less important for systemic risk mitigation purposes. As was noted in the G20 Summit in November 2008: “... *our financial markets are global in scope, therefore, intensified international cooperation among regulators and strengthening of international standards, where necessary, and their consistent implementation is necessary to protect against adverse cross-border, regional and global developments affecting international financial stability. Regulators must ensure that their actions support market discipline, avoid potentially adverse impacts on other countries, including regulatory arbitrage, and support competition, dynamism and innovation in the marketplace.*”³

Without a “course correction,” U.S. and EU regulatory reform efforts have the potential to create a patchwork quilt of reforms which can only increase complexity to market participants, regulators, and supervisors, and limit the capacity of capital markets to meet clients’ needs. In addition, the ambiguity and legal uncertainty created by extraterritorial legislation has the potential to actually foster systemic risk by making it more difficult for regulators to monitor and capture activity in financial markets. As our shared goal and interest is to implement reforms in a coordinated and consistent manner, we hope that the issues that our paper highlights can be

³ [Declaration of the Summit on Financial Markets and the World Economy](#). The White House. 15 November 2008. Retrieved 14 April 2012.

explored, discussed, and resolved through the continued interaction in the Financial Market Regulatory Dialogue (FMRD) and other forums.

As the world's largest capital markets, the U.S. and the EU are well-placed to play a leadership role in developing common global approaches to regulation. We appreciate your attention to these issues and look forward to continued dialogue with you and your staffs on this issue.

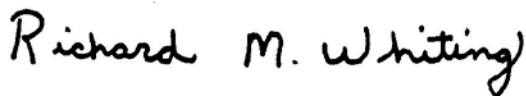
Sincerely,



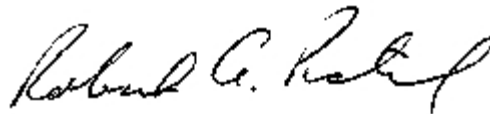
Simon Lewis
CEO
GFMA



Sally J. Scutt
Managing Director
IBFed



Richard M. Whiting
Executive Director and General Counsel
The Financial Services Roundtable



Robert Pickel
CEO
ISDA

CC: G20 Finance Ministers
FSB Chairman Mark Carney
FSB Secretariat

ANNEX 1

Global Financial Markets Association

The Global Financial Markets Association (GFMA) brings together three of the world's leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London and Brussels, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA. For more information, please visit <http://www.gfma.org>.

The Financial Services Roundtable

The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for \$92.7 trillion in managed assets, \$1.2 trillion in revenue, and 2.3 million jobs.

IBFed

The IBFed is the representative body for national and international banking federations from leading financial nations around the world. Its membership includes the American Bankers' Association, the Australian Bankers' Association, the Canadian Bankers Association, China Banking Association, the European Banking Federation, the Indian Banks' Association, the Japanese Bankers' Association, Korean Federation of Banks, Association of Russian Banks, the Bankers' Association of South Africa and FEBRABAN (Federacao Brasileira de Bancos). This worldwide reach enables the Federation to function as the key international forum for addressing legislative, regulatory and other issues of interest to the global banking industry.

ISDA

Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 800 member institutions from 56 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

ANNEX 2

Regulatory Reform Programme – Extraterritoriality Issues

Background

The recent financial crisis has led to an unparalleled period of regulatory innovation and change impacting the financial services sector. Change on the scale of the US Dodd-Frank legislation and the EU programme of regulatory reform brings with it a unique opportunity to build a regulatory framework that achieves significant gains in levels of protection for customers and levels of financial stability for the global economy.

However, undertaking reform on such a significant scale also risks making changes that are broader in scope than may be necessary or which are focused purely on domestic concerns or issues whilst ignoring the impacts on wider, international financial markets. This can lead to regulation that is inappropriately extraterritorial in effect and elements of regulation that diverge significantly between major financial centres. This is a danger that is particularly pronounced in an industry that is as global and interconnected in nature as financial services.

At the end of each section of this paper we have referred to specific examples of legislation or regulation which illustrate the concerns to which measures are giving rise. In most cases further detail on the potential impact of this legislation or regulation is set out in the Table (Annex 3) prepared with Clifford Chance attached which is still work in progress, because there are measures still being discussed where the final outcome is not clear and the references to section numbers below are references to sections of this Table (Annex 3).

1. Duplicative requirements

Regulators in the US and EU have been calling for consistency in implementing G20 and other reforms, to avoid regulatory arbitrage. This is welcome and indeed crucial to avoid the danger identified under the next heading below. However, introducing identical or similar requirements in different jurisdictions could lead to some entities becoming subject to multiple overlapping regulatory regimes. This could have the effect of:

- Reducing the quality or usefulness of information available to regulators (e.g. where the same trade is required to be reported multiple times);
- Introducing unnecessarily duplicative requirements; and distorting competition as between market participants by the uneven application of duplicative regimes;
- Encouraging participants to make venue choices based on avoidance of administrative complexity, potentially reducing the focus upon execution quality and fragmenting international markets;
- Increasing the compliance burden or costs of compliance for regulated entities without achieving any additional benefits by way of customer protection or market stability (e.g. where such entities are required to comply with requirements in several different jurisdictions, firms will need to build systems to ensure compliance with the various requirements). There are also cases where additional obligations can be imposed on non-regulated entities.

Examples of legislation or regulation which may result in duplicative requirements are:

In the EU: Regulation 1060/2009 on credit rating agencies (“CRAs”) (see attached table, section 1)¹; the provisions on remuneration and credit risk retention (“skin in the game”) in the Capital Requirements Directives 2 & 3 (section 5); the requirements in the European Market Infrastructure Regulation for counterparties to report transactions in derivatives (section 9); the disclosure requirements in the Short Selling Regulation (section 11); and the provisions of the Market Abuse Directive (section 13) and the proposed Regulation on energy market integrity and transparency (section 12).

In the US: the proposed US rules on credit rating agencies (section 29); the registration requirements for non-US swap dealers and major swap participants under Dodd Frank (section 22) together with the Section 165/166 enhanced supervision framework for foreign banks; the provisions for credit risk retention under Dodd Frank (section 30); and the reporting obligations imposed by the Office of Financial Research (section 33).

2. Incompatible or conflicting requirements

In the past, regulators have commented that duplicative regulation is not a particular concern, as firms subject to multiple regimes should comply on a “highest common factor” basis. However, it may not always be possible for a regulated entity (or another entity subject to the relevant regulation) to comply with the requirements it may be subject to in every jurisdiction. For example, if an entity is subject to a clearing requirement in two jurisdictions, it may not be possible for it to comply with both requirements (unless legislation is introduced in at least one jurisdiction recognizing CCPs authorized or registered in the other jurisdiction).

Another example would be reporting requirements where regulators require disclosures or reports to be made exactly as specified in local legislation: for example, where reports are to be made in a particular format, or exact figures must be given calculated according to national requirements (e.g. UK large shareholding reporting requirements, loan-level data requirements for securitisation transactions), and penalties apply if the reports are not made in this way.

Similar issues arise in relation to regulators' powers to impose bans on particular products or practices. If firms are prohibited from carrying on particular trading practices (e.g. short selling, high frequency trading) unless they comply with particular conditions, and different and incompatible conditions apply in different jurisdictions, the answer may simply be to stop trading in that product / jurisdiction.

As discussed at 1. above, these circumstances may shape market participants’ choices about business location and venue of execution, leading to fragmented markets, the structure of which is distorted by conflicting or even incompatible regulation.

Examples of legislation or regulation which may result in incompatible or conflicting requirements are:

In the EU: the proposal to apply prudential requirements to non-EU subsidiaries of EU persons under the Capital Requirements Directive IV (section 6); the obligation to clear OTC derivatives on a CCP established in the EU under the European Market Infrastructure Regulation unless the CCP is established in a jurisdiction recognised by ESMA (section 7); the requirements of the European Central Bank and the Bank of England for loan-level data disclosure for securitisation transactions.

¹ But note that while Section 939A DFA seeks to *eliminate* CRA references, EU concerns are currently more focused on *over*-reliance on CRAs – so there are issues of inconsistency of objectives; see, in addition, Section 3 below.

In the US: the restrictions on proprietary trading under the Volcker rule (section **19**); the margin requirements under Title VII of Dodd Frank (section **23**); the position limits under Title VII of Dodd Frank (section **26**); the provisions for credit risk retention under Dodd Frank (section **30**); the requirements of the SEC under Reg AB for loan-level data disclosure for securitisation transactions.

3. Distortion of competition/reduction of customer choice

Where regulation is applied extra-territorially, it may have the effect of distorting competition in particular markets. For example, not all firms operating in a particular jurisdiction may be subject to the same degree of regulation. If local entities are not subject to (e.g.) capital or margin requirements, but firms operating cross-border are, then local entities will have a competitive advantage.

Regulation may also have the effect of restricting the ability of regulated entities to carry out cross-border business with entities in other jurisdictions (as service providers, clients or counterparties). For example, EU firms will be restricted from using ratings issued by “unendorsed” non-EU CRAs for regulatory purposes, non-EU fund managers are restricted from marketing AIFs to investors in the EU, the removal of the private adviser exemption in the Investment Company Act may restrict non-US investment advisers from accepting US customers, and the Volcker rule prohibition on proprietary trading may restrict customer choice as US banks are precluded from participating in certain markets and non-US banks with US operations might be subjected to extraterritorial restrictions to their worldwide trading and funds business which would not apply to non-US banks having no US operations. In addition, the (inadvertent) discrimination of non-insured US branches of non-US banks vis-à-vis US-incorporated banks in the “swap desk push out provision” (Section 716) of the Dodd-Frank Act may reduce customer choice in the US.

Removal of cross-border business exemptions and requirements for entities to establish a local subsidiary and obtain authorization may reduce willingness of non-EU entities to do business in the EU, reducing competition within the EU and reducing customer choice.

Some firms may need to restructure their group so that they use locally regulated booking entities / risk management entities. This is likely to result in increased costs for that entity, making it less competitive, or in it passing on these increased costs to end clients. In a similar vein, some firms such as non-bank financial companies may have legal structures that differ from bank holding companies; this can result in unique regulatory challenges for the non-bank such as how regulatory capital is calculated.

Problems in this area can also reduce the ability of developing countries to access funding from developed markets.

Regulatory reforms which apply differentially as between participants on the basis of location or origin distort the provision of services, fragment markets and distort competition in those markets. There is insufficient recognition that financial markets (especially those for instance in derivatives) are global, and are inhabited by global firms offering global capabilities and scale, seeking to compete on a level basis wherever they serve clients.

Examples of legislation or regulation which may distort competition or reduce consumer choice are:

In the EU: the potential restriction on EU firms using “unendorsed” non-EU credit ratings for regulatory capital purposes, the proposed mandatory requirements for issuers to rotate their appointed CRAs and the requirements for harmonised rating scales, all under proposed changes to Regulation 1060/2009 (section **1**); the restrictions on the activities of non-EU fund managers in the EU under the Alternative Investment Fund Managers Directive (section **2**); the Capital Requirements Directives 2, 3 & 4 (sections **4**, **5** and **6**); requirements of the European Market Infrastructure Regulation (sections **7**, **8**, **9** and **10**) and the Markets in Financial Instruments Directive (section **14**)

In the US: the proposed rules on determining systemic significance (section **16**); the FDIC funding requirements (section **17**); the proposed elimination under Section 939 DFA of the use of external credit ratings: for example, in calculating regulatory capital requirements for securitisations - this results in more punitive and risk-insensitive weightings in the US than in Europe; the removal of the private advisor exemption from the Investment Company Act (section **18**); the restrictions on proprietary trading under the Volcker rule (section **19**); and the proposed Rule 127B on conflicts of interest in securitisation transactions which could prohibit securitisation activity of a European affiliate whether or not it was involved in a securitisation in the US.

In addition, in the US, the swap dealer registration requirements for non-US entities who deal with US clients would seem to lead to US margin and other requirements applying to *all* business done by that non-US entity, including business it does with non-US clients. This will put such entities at a potentially significant competitive disadvantage relative to those institutions which deal with the same non-US client base but do not have to register as a Swap Dealer (because they do not face US clients) (sections **22** and **23**).

4. Unintended impact on clients / counterparties who are not directly subject to regulation

Some regulatory obligations imposed on regulated entities may also have an impact on clients or counterparties who are not directly subject to the relevant obligations. For example, if a financial counterparty in the EU is required to clear a trade, its counterparty (unless it is a counterparty that is exempt from EMIR or from the EMIR clearing requirement) will not have a choice about whether the trade is cleared or not. Similarly, while the EMIR text may be read to imply that margin requirements could – on occasion- be imposed on only one counterparty to a trade, this will have an impact on the other counterparty regardless of whether they are also subject to margin requirements. This may result in increased costs or reduced choice for clients.

Examples of legislation or regulation which may have an impact on clients or counterparties who are not directly subject to regulation are:

In the EU: the clearing and risk mitigation requirements under the European Market Infrastructure Regulation (sections **7** and **8**); the mandatory rotation of CRAs proposed under Regulation 1060/2009 (section **1**).

In the US: the requirements of the Foreign Account Tax Compliance Act (section **32**) and the single counterparty credit limit under section 165 notice of proposed rulemaking (NPR) could have an unintended impact on clients and counterparties as the 25% and 10% limits cause bank holding companies to unwind their positions.

5. Lack of process for mutual recognition or comparability

Some provisions of the proposed EU legislation contain requirements for mutual recognition and in some cases for Treaties to be negotiated between states (e.g. EMIR / trade repository recognition). In principle, mutual recognition is a valuable arrangement as a means to make regulation more efficient and to avoid having multiple sets of regulation applicable to a single legal entity. However, without a defined process for attaining such recognition, negotiating treaties may take a long time, or may never happen. Proposals do not seem to be being built into legislation in recognition of this and to address the problem. For example it would seem that it will simply not be possible to use a trade repository in a jurisdiction where there is no treaty with the EU.

Even if no Treaty is required, obtaining formal mutual recognition may depend on all sorts of political factors and it may, for example, be more appropriate for regulators to be able to make judgments

regarding which jurisdictions provide for an appropriate and comparable level of regulation, or to build in an element of flexibility regarding the criteria for recognition.

In principle, therefore, although mutual recognition clearly has an important potential role in reducing the problems to which extraterritorial measures can give rise, it does bring with it a number of challenges that we would urge regulators to take into account. It would be useful, in particular, for legislators and regulators to plan how they will manage the mutual recognition process before implementing any regulation or legislation requiring mutual recognition.

Requirements for exactly “equivalent” regulation or legislation run into similar problems: regulation may not be exactly equivalent in other jurisdictions for a number of reasons e.g. requirements of local law make it impossible for identical regulation to be imposed, the local market is not yet sufficiently developed for identical regulation to be imposed, or the different characteristics of locally originated assets, local business models or local financing structures. A broader concept of equivalence should be built in referring to *the effect* of the regulation or legislation. In addition, as is the case for mutual recognition, there must be a clear process in place for making comparability determinations (i.e. standards/factors). Without such process, there will continue to be a great deal of uncertainty as to the circumstances which give rise to findings of comparability.

Examples of legislation or regulation which lack a clear process for mutual recognition or findings of comparability are:

In the EU: Regulation 1060/2009 on CRAs (section 1); the Alternative Investment Fund Managers Directive (section 2); and the European Market Infrastructure Regulation (section 10).

In the US: Dodd-Frank Act Sec. 712 – “Definitions of a swap and swap dealers”; Sec 721 – “Registration of swap dealers”; Sec 725 – “Derivative Clearing Organisations”; Sec. 733 – “Swap Execution Facilities”; Sec. 738 – “Foreign Boards of Trade”, and Sec. 763 – “Amendments to the Securities Exchange Act of 1934 - Section 3C – “Clearing of Security-Based Swaps” (sections 22 and 25).

6. Regulatory uncertainty and disproportionate compliance burden

This seems to be an issue both in the EU, where legislation has been proposed giving regulators broad powers to impose temporary emergency restrictions, and in the US, where cross-border aspects of Dodd-Frank implementing regulation have been delayed. As we saw with the emergency short selling bans / reporting regimes imposed in 2008 / 2009, this sort of power can lead to uncertainty for the firms required to comply. They are required to monitor the situation in all countries where they trade, and may be required to set up systems on short notice to comply (or to report / monitor their systems manually if the ban / reporting requirement is only temporary). This can make firms reluctant to trade in particular markets to the detriment of their clients.

Where local regimes have different territorial scope, it can make monitoring and compliance far harder (e.g. a firm would not just have to monitor the markets in which it is trading, but may also have to monitor local regulation in other jurisdictions where a particular security is listed, or where a particular entity is established). Where the extraterritorial scope of emergency powers is unclear (e.g. EU short selling regulation emergency powers), it may be almost impossible for firms to predict which jurisdictions they should be monitoring.

More generally, cases can arise where the precise effect of an extraterritorial rule has to be understood in order for a firm to determine what restructuring is necessary. When implementation dates are set, this aspect is not always recognised.

Examples of legislation or regulation which may result in regulatory uncertainty are:

In the EU: the Short Selling Regulation (section **11**) and the Markets in Financial Instruments Directive (section **14**)

In the US: Application of Section 165 Dodd-Frank (SIFIs requirements) to non-US banks (Fed proposal still pending), Title VII of the Dodd-Frank Act (where SEC and CFTC have announced, but still not proposed, guidance on the cross-border aspects) (section **25**), the application of the Volcker rule (US regulators' October 2011 proposal contained 1,300 questions and was even mute on some aspects such as the compliance regime for non-US banks with US operations, while the statutory deadline for a final rule is July 2012), statutory oversight resulting in discrimination of US branches of non-US banks in swap desk push out rule (Section 716 Dodd-Frank Act) may not be corrected either by Fed or US Congress before statutory implementation deadline (July 2013).

Some legislation with extraterritorial effects has particularly high implementation burdens relative to the benefits being sought.

A general difficulty that gives rise to cost burdens is the case where the timing of implementation in different jurisdictions is not aligned, which creates uncertainty about how cross-border transactions should be dealt with in the interim period.

Examples of legislation or regulation which may result in disproportionate compliance burden:

In the EU: the requirements of the Markets in Financial Instruments Directive (section **14**)

The proposed revision of the EU Markets in Financial Instruments Directive (MiFID/MiFIR) would severely curtail access to the EU for financial firms from outside the EU. In particular, equivalence and reciprocity requirements and the need to establish branches for services into the EU will reduce product offering and hence consumer choice without commensurate increases in consumer protection.

In the US: the requirements of the Foreign Account Tax Compliance Act (section **32**), which will require non-US financial institutions to implement unprecedented customer due diligence, documentation, reporting and certification measures.

ANNEX 3

Table: EU and US Regulatory Reform Programme – Extraterritoriality Issues

The financial crisis has triggered a broad ranging programme of regulatory reform in both the EU and the US. However, the legislation currently being adopted or implemented will have effects beyond the EU or US borders and the purpose of this note is to highlight the principal areas of potential extraterritorial impact.

The US Dodd-Frank Act creates a legal framework which requires extensive rule-making by the US regulators responsible for its implementation. However, in many cases the implementing rules have been proposed but not yet adopted and are still under discussion.

The EU legislative programme is less advanced. The EU programme is being implemented by a series of separate pieces of legislation and in only a few cases has the legislation been finally adopted. In many cases, the EU legislation is still in the process of negotiation or has not yet been formally proposed. Even after primary legislation has been adopted, the final impact may often depend on implementing EU directives or regulations or national implementation rules.

Therefore, at this stage, it is not possible fully to assess the extraterritorial impact of the legislation in either the US or the EU. However, in many cases, the existing proposals indicate areas of possible extraterritorial impact.

This note is not intended to be comprehensive or to provide legal advice on any particular course of action.

EU Legislation and Legislative Proposals

	Legislation (status)	Provision	Possible extraterritorial/ business impact	Comment
1.	<p>Regulation on credit rating agencies (CRAs) (EC) No. 1060/2009</p> <p>(Adopted and being implemented, Directive and Regulation have been proposed reforming the original regulation)</p>	Restriction on EU firms using ratings issued by non-EU CRAs for regulatory purposes (unless the rating is endorsed by an EU affiliate of the CRA or the CRA is certified as equivalent)	<p>Restriction on reliance on non-EU ratings by EU users</p> <p>Reduced ability of EU firms to use ratings issued by non-EU CRAs for regulatory purposes, possible reduction in availability of ratings for non-EU instruments, reduction in willingness of EU firms to invest in instruments which are only rated by non-EU CRAs</p>	The restrictive nature of the conditions for endorsement may make it difficult for major CRAs to endorse the ratings produced by all their affiliates, particularly those in countries that have not yet adopted legislation regulating CRAs
2.	<p>Alternative Investment Fund Management Directive</p> <p>(Adopted and being implemented)</p>	Restrictions on non-EU fund managers marketing alternative investment funds in the EU	<p>Restrictions on provision of cross-border services to EU investors</p> <p>Reduced competition and reduced choice for investors in the EU, reduced ability for non-EU funds to raise capital in the EU (particularly from the retail market)</p>	Impact may be mitigated by transitional provisions and potential passport arrangements for non-EU AIFM
3.		Requirements for non-EU fund managers managing EU alternative investment funds to be authorised in the EU	<p>Restriction on cross-border services to EU funds</p> <p>EU funds will have reduced access to non-EU managers, fewer options for fund structures, possibility that existing EU funds with non-EU managers may be required to restructure</p>	May be limited number of fund managers affected
4.	Capital Requirements Directive 2 &	Requirements for banking groups (or sub-groups) whose head office is in the EU to apply the provisions	<p>Application of requirements to non-EU subsidiaries of EU persons</p> <p>EU groups' ability to compete in non-</p>	Non-EU subsidiaries of EU groups may also be subject to a duplicative local regime

	Legislation (status)	Provision	Possible extraterritorial/ business impact	Comment
	3 - 2009/111/EC and 2010/76/EU (Adopted and largely implemented)	on remuneration to all entities (including non-EU entities) in the group/sub-group, subject to limited exceptions	EU markets is adversely affected to the extent that EU requirements are more restrictive	
5.		Other requirements, including "skin in the game" and trading book capital requirements, also apply to all entities (including non-EU entities) in a group/sub-group headed by an EU entity	Application of requirements to non-EU subsidiaries of EU persons EU groups' ability to compete with non-EU firms (both within and outside the EU) is adversely affected to the extent that EU requirements are more burdensome	Implements "Basel 2.5" Non-EU subsidiaries of EU groups may also be subject to local capital requirements
6.	Capital Requirements Directive 4 (Formally proposed)	Higher capital requirements likely to apply to all entities (including non-EU entities) in a group/sub-group headed by an EU entity	Application of prudential requirements to non-EU subsidiaries of EU persons EU groups' ability to compete with non-EU firms (both within and outside the EU) is adversely affected to the extent that EU requirements are more burdensome	Will implement Basel III, including the additional buffer for globally systemically important banks Non-EU subsidiaries of EU groups may also be subject to local capital requirements
7.	European Market Infrastructure Regulation (Derivatives and CCPs) (Formally proposed – under negotiation between Council and Parliament)	Obligation on EU counterparties subject to the clearing obligation to clear transactions in eligible derivatives entered into with certain categories of non-EU person Obligations will also apply to transactions entered into between	Becoming more difficult to provide services on a cross-border basis (due to increased costs for counterparties becoming subject to the clearing obligation or difficulties connected with third party also being subject to local requirements) Possible impact on intra-group risk management EMIR contract obligations may	EU requirements may not be acceptable to counterparties (in particular where local requirements to clear on a CCP not recognized in the EU) Intra-group exemptions available in limited circumstances, including where the counterparty is established in a jurisdiction which the Commission considers to have in place equivalent obligations to those under EMIR

	Legislation (status)	Provision	Possible extraterritorial/ business impact	Comment
		certain categories of non-EU person	apply to contracts between two entities established outside the EU where the contract has a direct, substantial and foreseeable effect within the EU or where the obligation is necessary or appropriate to prevent evasion of EMIR. This has potential implications for entities that may well be subject to requirements in other jurisdictions.	
8.		<p>Obligation on EU counterparties to adopt risk mitigation techniques, including margin, in relation to transactions with any counterparty (including non-EU persons)</p> <p>Obligations will also apply to transactions entered into between certain categories of non-EU person</p>	<p>Becoming more difficult to provide services to non-EU persons</p> <p>Reduction in competitiveness of EU firms in jurisdictions with differing/no similar margin requirements for particular counterparties, cost implications for intra-group risk management</p>	<p>EU requirements may not be acceptable to counterparties (e.g. where local counterparties are exempt from local margin rules)</p> <p>Intra-group exemptions available in limited circumstances, including where the counterparty is established in a jurisdiction which the Commission considers to have in place equivalent obligations to those under EMIR</p>
9.		Obligation on EU counterparties to clear eligible contracts, report transactions and risk manage uncleared transactions may apply to non-EU branches of EU counterparties	<p>Application of EU provisions to non-EU branches of EU persons</p> <p>Possibility that non-EU branches may be subject to duplicative or inconsistent regulation, where they are regulated by the EU and also by the jurisdiction where they are established. This may result in increased compliance costs or prevent non-EU branches from carrying on some kinds of activity</p>	Also it is unclear the extent to which these rules apply to the activities outside the EU of non-EU persons with a branch in the EU

	Legislation (status)	Provision	Possible extraterritorial/ business impact	Comment
			Reduction in competitiveness of EU firms if they are required to post collateral 'one-way' while non-EU firms are not required to do so for similar transactions (with clearing/margin-exempt firms)	
10.		Restriction on non-EU CCPs providing services to clearing members/clients established in the EU unless CCP recognised by ESMA as subject to equivalent regulation	Restriction on non-EU persons providing services to EU persons Reduced competition and reduced choice for firms in the EU. May also prevent EU firms from carrying on business in some markets if they cannot become members of the relevant CCP	May also restrict non-EU CCPs providing services to non-EU firms acting outside the EU if the firm maintains a branch in the EU
11.	Short Selling Regulation (Text is adopted, comes into force in November 2012)	Private disclosure to EU competent authority of any net short position in EU shares or sovereign debt or uncovered positions in sovereign CDS (when the ban on uncovered CDS is suspended) above certain thresholds Public disclosure of any net short position in EU shares above specified threshold Ban on uncovered short sales of EU shares and sovereign debt and uncovered sovereign CDS	Application of EU requirements to persons outside the EU Increased compliance costs for firms required to comply with multiple regimes, public disclosure requirement may reduce willingness of non-EU firms to trade in EU shares	Text explicitly states that disclosure obligations apply to persons outside the EU as well Proposal does not specify the territorial scope of the restriction on uncovered short sales of EU shares and sovereign debt and uncovered sovereign CDS or the possible additional restrictions that can be imposed in exceptional circumstances (the latter, at least, may also have extraterritorial effect)

	Legislation (status)	Provision	Possible extraterritorial/ business impact	Comment
		Additional restrictions may be imposed in exceptional circumstances		
12.	Regulation on energy market integrity and transparency (Adopted, came into force 28 December 2011)	Prohibition of insider dealing in energy products and market manipulation on EU wholesale energy markets Transaction reporting and registration regime for market participants	Application to persons outside the EU	Unclear whether prohibition against insider dealing is intended to be limited to dealings on or related to EU wholesale energy markets (or applicable generally) Increased compliance costs for firms required to comply with multiple regimes, concerns about sanctions for breach may lead non-EU firms to avoid trading in EU wholesale energy markets
13.	Market Abuse Regulation and Market Abuse Directive II (Formally proposed)	Current directive applies to persons outside the EU Proposed regulation would extend the scope of the market abuse regime to a wider range of instruments and behaviours Proposed directive would create a criminal market abuse regime	The proposed regulation applies to activity within and outside the EU in relation to the relevant instruments	Increased compliance costs for firms required to monitor behaviour in relation to an increased range of instruments Uncertainty about which instruments are within scope of the regime
14.	Markets in Financial Instruments Directive II and Markets in	Requirement for third country investment firms to seek authorization for branches in the	Removal of existing national exemptions for cross border business	Reduced ability for third country investment firms to deal with EU clients and

	Legislation (status)	Provision	Possible extraterritorial/ business impact	Comment
	<p>Financial Instruments Regulation</p> <p>(Formally proposed)</p>	<p>EU</p> <p>Requirement for third country investment firms providing cross border services into the EU to register with ESMA (and to restrict cross-border business to eligible counterparty business)</p> <p>Persons established in the EU may receive investment services from a third country firm at their own exclusive initiative and in these circumstances the services should not be deemed as provided in the territory of the Union [delete. Retail clients may only receive investment services from a third country firm if it has a branch in the EU].</p> <p>Third country investment firms may only obtain authorization for branches or register with ESMA if the third country provides for equivalent regulation and reciprocal recognition</p> <p>Obligation to conclude transactions in eligible derivatives contracts on regulated markets, MTFs, OTFs or third country trading venues (where the third country provides for</p>	<p>Lack of clarity regarding when a person in the EU would be considered to receive investment services "only at their exclusive initiative"</p> <p>Lack of clarity regarding treatment of existing relationships between third country investment firms and EU clients and counterparties</p> <p>Barrier to cross border business as EU firms may not be able to trade on a trading venue with non-EU firms if those non-EU firms are not able to access EU trading venues. May also prevent EU firms from carrying on business in some markets if they cannot access a relevant third country trading venue</p>	<p>counterparties</p> <p>Potential for unequal application of MiFID II to EU and non-EU firms, as it is not clear whether the exemptions available to EU firms under MiFID II will also be available to non-EU firms wishing to provide cross border services into the EU</p> <p>Requirement for "equivalence" and "reciprocity" likely to restrict the number of third country firms which are able to register with ESMA or establish a branch in the EU</p>

	Legislation (status)	Provision	Possible extraterritorial/ business impact	Comment
		equivalent regulation and reciprocal recognition)		
15.	New EU Data Protection Framework	Updating of 1995 EU legislation to take account of technological advances. Concepts include “privacy by design” and “right to be forgotten”. Increased burden on all firms to demonstrate compliance. Maximum fine of 2% of global turnover.	ET effect applies to all entities offering goods or services to individuals in the EU.	

Dodd-Frank Act and Related Rules

	Legislation (status)	Provision	Possible extraterritorial/ business impact	Comment
16.	Determination of systemic significance (Final rule)	A non-US bank with US banking operations would be treated as systemically significant if it has US\$50bn or more in consolidated <u>global</u> assets	Potential limit on activities of non-US banks in the US Enhanced prudential requirements, increased capital and compliance costs	Would apply Act's enhanced prudential requirements to non-US banks on the basis of global assets, irrespective of how significant their operations are in the US
17.	FDIC funding (Implemented rules)	FDIC authorized to charge US banks risk-based assessments by reference to the bank's consolidated total assets minus average tangible equity	Potential limit on US activities of non-US banks Potential constraint on activities of US banks outside the US	Only applies to US banking entity and its subsidiaries (not the holding company)
18.	Investment advisers (Final rules)	Act eliminates private adviser exemption from Investment Advisers Act	Restriction on activities of non-US advisers who have US clients or who advise funds with US investors Increased costs (including registration and compliance costs) for non-US advisers that register under the Advisers Act, or reduced ability to accept US clients and fund investors	Narrow exemption for non-US advisers may not mitigate these effects due to low thresholds Exemption for non-US advisers that manage only private funds in the US is broader, but conditional on annual reporting to the SEC Many non-US advisers may have to register in the US or alter their business model
19.	"Volcker rule" ² (Proposed rules)	Prohibition on proprietary trading and sponsorship and investment in hedge funds and private equity funds by banks and their affiliates	Application to non-US affiliates (and branches) of US banks and non-US banks with US operations Requirements may distort competition because US requirements not matched by	

² Title VI

			corresponding requirements in other countries	
20.		<p>Limited exception for proprietary trading:</p> <p>Non-US banks may conduct proprietary trading if it is "solely outside the United States". This exception is not available to non-US branches or affiliates of US banks</p>	Impact on activities outside the US of non-US banks which have a presence in the US	Non-US banks may be prohibited from trading any assets if there is some interaction with a US entity (e.g. the use of a US broker, US execution facility or trading personnel)
21.		<p>Limited exception for funds:</p> <p>Non-US banks may invest in and/or sponsor a fund "solely outside the United States" if such fund is not offered to any US persons. This exception not available to non-US branches or affiliates of US banks.</p>	Impact on activities outside the US of non-US banks which have a presence in the US	Offshore funds would effectively be discouraged from selling to US investors because such sales would result in prohibitions on investment in or sponsorship of the funds by foreign banks
22.	Registration requirements (Final rule)	Non-US swap dealers and major swap participants (MSPs) required to register with CFTC/SEC if they conduct business with US persons	Restriction on activities of non-US swap dealers or MSPs with US clients and counterparties	Non-US swap dealers or MSPs that register may be subject to capital requirements and inspection and supervision by US regulators, as well as other requirements (such as margin rules for uncleared transactions)
23.	Margin requirements (Proposed rules)	<p>Non-US branch or subsidiary of a US bank (or other entity) that registers as a swap dealer would have to comply with US margin requirements for <u>all</u> its swaps, including swaps with non-US counterparties</p> <p>Non-US entities that register as swap dealers would have to comply with US margin requirements for swaps with US persons, including non-US branches of</p>	<p>Restriction on activities of non-US branches or subsidiaries with non-US persons</p> <p>Restriction on activities of non-US swap dealers with US clients and counterparties</p>	<p>Non-US branches or subsidiaries of US banks at a competitive disadvantage with respect to non-US clients as against non-US banks</p> <p>No exemption for inter-affiliate transactions</p>

		<p>US banks (or guaranteed by US persons)</p> <p>US swap dealers would have to comply with US margin requirements for all swaps, including swaps with non-US persons</p>	<p>Restriction on activities of US swap dealers with non-US clients and counterparties</p>	
24.	<p>Capital requirements for non-bank swap dealers and security based swap dealers</p>	<p>The CFTC and SEC must impose capital requirements for non-bank swap dealers and security-based swap dealers. (Title VII, Section 731)</p>	<p>Sophisticated non-bank financial companies could be subject to grid or haircuts if unable to use risk based capital calculations and placed at a competitive disadvantage.</p>	<p>Non-US persons registered as non-bank swap dealers/security based swap dealers should be permitted to comply with capital requirements established by home/host country regulators so long as the home/host country is a signatory to the Basel Accords.</p> <p>Swap dealers should be permitted to use internal models for computing market risk and counterparty credit risk charges for capital purposes if such models have been approved by a foreign regulatory authority and are subject to periodic assessments by such foreign regulatory authority</p>
25.	<p>Extraterritorial reach of Title VII and registration requirements for swap dealers</p>	<p>The CFTC adopted regulations to establish a registration process for swap dealers and major swap participants (Title VII, Section 721) and will soon finalize rules defining a swap and swap dealer (Section 712) without defining the extraterritorial reach of Title VII (Section 722)</p>	<p>Provisional registration without knowing the extraterritorial reach of Title VII will require costly, disruptive and time consuming legal restructuring involving extensive redocumentation of client agreements, reallocation of scarce capital, reassignment of personnel and expensive systems redevelopment.</p>	<p>The CFTC should limit the extraterritorial reach of Title VII and work with other jurisdictions to harmonize the rules where possible and avoid conflicting and duplicative rules as necessary.</p>
26.	<p>Position limits, large trader reporting (Final rules)</p>	<p>Rules imposing aggregate position limits on 28 physical commodities traded on exchanges/SEFs/foreign boards of trade and certain OTC swaps</p> <p>Spot month limits will come into effect 60 days after further definition of</p>	<p>Will apply to non-US entities trading on markets in the US or with US counterparties in certain OTC swaps</p>	<p>Definition of "bona fide hedge" is narrowed: may result in increased volatility and decreased ability to hedge</p>

		<p>"swap" is finalised</p> <p>Bona fide hedges in physical commodities are excluded</p> <p>Reporting obligation for certain OTC swaps</p>		
27.	<p>Swap trading and sales compliance</p> <p>(Proposed rules and self-actuating provisions)</p>	<p>Rules on manipulation and anti-fraud provisions (Title VII section 753)</p>	<p>May apply to non-US transactions with an effect on the US market or on US investors</p>	<p>Could apply to non-US transactions if the CFTC took the view that there was (i) an effect on the US market or on US investors or (ii) if there was significant conduct in the US. Historically regulators (including the CFTC) have taken aggressive views regarding the extent of their extra-territorial jurisdiction. The CFTC could try to claim jurisdiction over non-US OTC interest rate swaps even if not cleared/executed in the US if the CFTC felt there was an effect on US markets or if there was fraud/manipulation committed in the US.</p>
28.	<p>Swap desk push out requirement (Section 716 Dodd-Frank Act)</p>	<p>Prohibits federal assistance (i.e. access to Fed facilities like discount window and FDIC insurance / guarantees) to registered swap dealers</p>	<p>US branches of non-US banks would have to push out more swap business, if they want to retain Fed discount window access, than US-incorporated banks, which may continue swap activities related to bona fide hedging and traditional banking activities.</p>	<p>Discriminates US branches of non-US banks in the US swap market. Statutory oversight may not be corrected by Fed (regulatory implementation is due July 2013); doubtful whether Congress will approve correcting amendment (such as contained in current H.R. 1838 including the Representative Himes amendment).</p>
29.	<p>Credit rating agencies</p> <p>(Proposed rules)</p>	<p>Requirements apply to non-US CRAs registered in the US</p>	<p>Affects global activities of CRAs registered in the US</p>	
30.	<p>Credit risk retention</p> <p>(Proposed rules)</p>	<p>Securitisers must retain a relevant economic interest (Subtitle D of Title IX, section 941)</p> <p>Any securitiser to retain not less than 5%</p>	<p>Applies to non-US transactions subject to a safe harbour</p>	<p>Applies both to transactions registered with the SEC under the Securities Act 1933 and to those exempt from registration. As a result, these restrictions will apply both to public and private transactions in the US</p>

		of the credit risk for certain assets		(with a very limited safe harbour for non-US transactions selling only a small portion into the US).
31.	Conflicts of Interest (Proposed Rule)	Securitisation transactions participants and their subsidiaries and affiliates are not to engage in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity. (Section 621)	Applies to all affiliates and subsidiaries of securitisation participants regardless of location.	Applies to both cash and synthetic asset-backed securities transactions. Applies both to transactions registered with the SEC under the Securities Act 1933 and to those exempt from registration. As a result, these restrictions will apply both to public and private transactions in the US.
32.	Foreign Account Tax Compliance Act (Self-actuating provisions, delayed effective date)	Financial institutions outside the US must submit annual reports to the US Treasury on their US clients and corporates with individual beneficial owners who own at least 10% of the equity and who are US taxpayers.	Directly targeted at firms outside the US. More than one hundred thousand non-US companies (Foreign Financial Institutions, or FFIs) which are active in the financial services sector will be affected. FFIs will have to comply with both the laws of their own jurisdiction and also with FATCA. FFIs will be faced with the choice of complying with either local law or US law.	Firms will suffer a 30% withholding tax on US source income and on sale proceeds of US assets under FATCA. Firms will be forced to close the accounts of non-compliant US account holders, although this may breach local equalities legislation. FATCA will require FFIs to implement unprecedented customer due diligence, documentation, reporting and certification measures. The compliance burden will be disproportionate. An Ernst and Young survey of 12 Tier I financial firms noted (i) they each had an average of 26 million accounts of which 62,000 were US FATCA accounts, and (ii) each firm faced an average FATCA implementation cost of €179 million. Proposed FATCA guidance for pass thru payments will be extremely burdensome if not outright unfeasible. .
33.	Office of Financial Research	US Treasury has established the OFR to gather transaction and position data from	US branches and affiliates of non-US banks will be subject to the	The OFR has the authority to require financial companies to submit "periodic or

	(OFR)	other government agencies and financial companies	OFR's data collection requirements	other reports" to assess threats to the financial stability of the US
34.	Orderly Liquidation Authority / Living wills (Proposed & final rules)	Any non-US banking organization with US banking operations and \$50 billion or more in total worldwide consolidated assets will be subject to the US "living wills" requirements, including requirements to provide extensive information to US regulators.	Impact on non-US banking organization operating in the US even if US operations are minimal	The US regulators intend to use the Living Wills as a supervisory tool. Information provided through the relevant reporting requirements may result in heightened supervisory scrutiny. US regulators may insist on funding strategies that support US entities to the detriment of non-US affiliates. A deficient living will may subject the covered company (or any of its subsidiaries) to more stringent capital, leverage or liquidity requirements, or impose restrictions on its growth, activities or operations. Failure to remedy deficiencies within two years could lead to an order by the regulators to divest assets or operations as necessary to facilitate an orderly resolution.

	Legislation (status)	Provision	Possible extraterritorial/ business impact	Comment
35.	Determination of systemic significance (Proposed rules)	A non-US bank with US banking operations would be treated as systemically significant if it has US \$50bn or more in consolidated <u>global</u> assets	Potential limit on activities of non-US banks in the US Enhanced prudential requirements, increased capital and compliance costs	Would apply Act's enhanced prudential requirements to non-US banks on the basis of global assets, irrespective of how significant their operations are in the US
36.	FDIC funding (Implemented rules)	FDIC authorized to charge US banks risk-based assessments by reference to the bank's consolidated total assets minus average tangible equity	Potential limit on US activities of non-US banks Potential constraint on activities of US banks outside the US	Only applies to US banking entity and its subsidiaries (not the holding company)
37.	Investment advisers (Final rules)	Act eliminates private adviser exemption from Investment Advisers Act	Restriction on activities of non-US advisers who have US clients or who advise funds with US investors Increased costs (including registration and compliance costs) for non-US advisers that register under the Advisers Act, or reduced ability to accept US clients and fund investors	Narrow exemption for non-US advisers may not mitigate these effects due to low thresholds Exemption for non-US advisers that manage only private funds in the US is broader, but conditional on annual reporting to the SEC Many non-US advisers may have to register in the US or alter their business model