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Achieving direct cross-border institutional access for capital market market intermediaries

The rapidly increasing global integration of capital markets makes it essential to address the barriers to banks and securities firms in one country conducting cross-border securities business with institutional investors[1] in other countries. The continuation of traditional forms of regulation in globally integrating markets obstructs regulatory efficiency, as well as restricting firms' ability to deliver services in a compliant manner.

In particular, it is necessary to move away from the current regulatory approach adopted in many countries, which requires firms to have (and act through) a locally regulated branch or subsidiary when dealing with local clients, even where they are institutional investors. Conditioning the access of institutional investors to the services of foreign banks and securities firms on those firms being able to maintain (and act through) a locally regulated office limits (or increases the cost of) the products and services available to local institutional investors, in effect depriving them of some of the benefits of the integration and globalisation of markets.

In summary, national regulatory regimes should facilitate cross-border provision of capital market services by exempting foreign firms from local licensing requirements, where the local investor is sufficiently expert to be able to protect its own interests or where the regulator can recognise (either on a mutual or unilateral basis) that the standards in the foreign firm's home state provide adequate protection to local investors. Even if the foreign firm is exempt from local licensing requirements for transactions with institutional investors, it may be subject to requirements to notify the local regulator that it has begun to provide services to local investors or to consent to the jurisdiction of the local courts. The local regulator may also subject the foreign firm to some local business conduct or market conduct rules (such as anti-fraud or market abuse rules). Thus, adjusting the regulatory regime to meet the needs of firms and investors in a more efficient way does not undermine the ability of regulators to fulfil their mandates.

Local licensing rules are a significant barrier to efficient cross-border wholesale markets

One of the principal barriers to the ability of banks and securities firms to transact cross-border securities business with institutional clients is local regulatory requirements which require firms to obtain a local broker-dealer or banking licence in order actively to seek business from local investors. In many countries, the only way of obtaining such a local licence is, in practice, to establish a locally incorporated subsidiary or, sometimes, a branch, after which that subsidiary or branch must then be actively involved in all business conducted with local clients and counterparties. In some cases, local law may also require that all business with local clients and

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[1] This paper uses the term 'institutional investors' to encompass the broad range of institutional entities, such as banks, securities firms, insurance companies, pension funds, collective investment undertakings and larger corporations, that access investment, issuance and risk management services from banks and securities firms. For these purposes, the term 'institutional investors' should also be understood to include other 'qualified investors', such as high net worth, sophisticated individuals who are also in a position to protect their own interests. In this paper, references to 'securities' should, where the context permits, be understood to include references to derivatives.

counterparties be booked in that local subsidiary or branch (so that the local subsidiary or branch acts as the counterparty to the client or carries the client's account).

This regulatory model is inefficient and prevents international firms meeting the needs of their institutional clients and counterparties.

If all countries adopted this regulatory model, an international investment bank would need to establish and fully staff a subsidiary or branch in every country in which it might wish to seek institutional clients or counterparties. Thus, the widespread adoption of this model would deny local institutional investors in many countries access to the full range of international firms' expertise and would restrict firms' ability to achieve economies of scale by centralising activities in financial hubs.

Where local booking is also required, the firm would also need to capitalise the local operation. This fragments the firm's capital resources and restricts the firm's ability to bring to bear its capital for the benefit of investors, by taking risk positions or providing risk solutions in the form of derivatives. Local large exposure or other rules may restrict the ability of a small, relatively lightly capitalised entity to lay off large positions through back-to-back transactions with affiliates. Fragmenting the firm's capital and positions across multiple local entities also restricts its ability to risk manage its positions centrally and multiplying intra-group transactions increases operational risks. In any event, institutional investors would often rather deal with the better rated, more highly capitalised entity within the group in preference to a less well capitalised, often unrated, local subsidiary.

Even where an international firm already has a local branch or subsidiary these rules impose significant restrictions. The expertise or transactional platform for particular products or services may be located in other entities. Structuring business so that it flows through the local entity can often be impractical or inefficient. It increases complexities and increases control and compliance risks and makes it even harder for firms to achieve consistent application of global compliance standards.

These restrictions are important in both developed and emerging economies, as firms increasingly seek to deal with clients and counterparties on a cross-border basis and as local institutional investors, including local corporations, look for diversified and sophisticated investment, financing and risk management solutions from a range of different sources to meet their own needs to participate in global markets. In this context, the traditional regulatory model acts as an increasingly burdensome and restrictive framework for international wholesale markets and detracts from, rather than supports achievement of, the highest compliance standards on a global basis.

A way forward through exemption or recognition

Regulatory regimes can facilitate cross-border institutional access in a number of ways that can strike an appropriate balance between the goals of investor protection and efficient capital markets.[2]

[2] See Global Securities Industry, "Recommendations for Liberalisation of Trade in Capital Markets-Related Services" (October 2005), available at http://archives2.sifma.org/international/pdf/wtoModel_.pdf and International

Local regulatory regimes can provide exemptions from local licensing requirements to foreign firms where they only transact business on a cross-border basis with local institutional investors, recognising that sophisticated investors do not need or want all the protections afforded by national securities laws. For example, the UK, Irish and Swiss regimes allow foreign firms to solicit business from local institutional investors without requiring a licence or registration.

Alternatively, local regulatory regimes can provide an exemption from the full burden of local licensing requirements to foreign firms that are licensed in a jurisdiction recognised by the local regulator as being well regulated (a form of unilateral or, if on a reciprocal basis, mutual recognition). It is generally more straightforward to recognise the adequacy of a foreign regulatory regime for these purposes where the foreign firm only transacts cross-border business with sophisticated investors who are capable of making their own investment decisions and assessing the credit of a particular counterparty. For example, Australia allows firms regulated in a number of other jurisdictions to transact cross-border business with local institutional investors without requiring a full licence (and without establishing a local presence). The US Commodities Futures Trading Commission has a similar regime (under its Part 30 rules) for foreign futures commission merchants.

Other regulatory techniques do not eliminate the need for a local presence

Other techniques can be helpful in reducing the impact of local licensing requirements, but do not eliminate the need to establish a local presence of some kind.

For example, in many regulatory regimes, the test for whether a foreign firm has triggered local licensing requirements is whether it has engaged in solicitation of local investors, in many cases without any distinction between solicitation of an individual retail investor or of the largest and most sophisticated local bank. In theory, this regime would allow local institutional investors to seek out foreign suppliers. But, in practice, unclear boundaries between solicited and unsolicited business and the highly interactive nature of wholesale markets - which makes it difficult to determine who solicited whom - can create significant legal and regulatory risk for cross-border business on any scale.

Local regulatory regimes can exempt foreign firms from local licensing requirements if a local firm "intermediates" the transaction, i.e. arranges the transaction (without carrying the account or booking the transaction on a principal basis). US securities laws provide for an intermediation model under which foreign broker-dealers can transact business with US customers and counterparties using a local affiliate to intermediate the transactions. Regimes that permit foreign firms to obtain a local licence by establishing a local branch (rather than a subsidiary), generally will avoid the costs of separately capitalising the local branch, but nonetheless will still experience increased costs and greater inefficiencies. In any event, these techniques do not avoid the need to establish a regulated local presence altogether.

Regional mutual recognition arrangements, such as those in the EU, can also reduce the impact of local licensing requirements by effectively allowing a third country firm to obtain access to investors across the region by incorporating a single local subsidiary in one member state.

Organisation of Securities Commissions, "the Regulation of Remote Cross-border Financial Intermediaries" (February 2004), available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD162.pdf.

However, these still discriminate against third country firms wishing to operate in the region through local branches and allow member states to impose licensing restrictions on direct cross-border business by third country firms, even with institutional investors.

Direct cross-border institutional access best serves a global marketplace

The model of direct cross-border institutional access is a better fit with a more globalised marketplace as it allows institutional investors to deal directly with the firms that provide the services and products they wish to obtain. Even if the foreign firm is exempt from local licensing requirements for transactions with institutional investors, it may be subject to requirements to notify the local regulator that it has begun to provide services to local investors or to consent to the jurisdiction of the local courts. It may also be subject to some local business conduct or market conduct rules (such as anti-fraud or market abuse rules) that preserve regulators' jurisdiction to intervene if problems arise. Under the model where access is given to firms from well regulated jurisdictions, the local regulator may also choose to recognise foreign jurisdictions for these purposes where it has in place appropriate information sharing arrangements with the regulator in that jurisdiction.

These arrangements better serve the needs of institutional investors that wish to have access to a full array of products and services from the broadest range of domestic and international suppliers. However, it is likely to be impractical to seek to limit this direct access to cases where the foreign firm deals only in "foreign" securities, as increasingly complex products and services make the distinction between domestic and foreign markets difficult to observe. For example, derivatives transactions may involve baskets of different securities and cash trades may involve switches between securities from different countries. In addition, institutional counterparties may wish to concentrate particular types of trading in a single relationship so as better to manage credit risks. In practice, the predominant role of local exchanges, currency factors and the comparative advantage of domestic firms in domestic securities and related services mean that those markets are likely to remain predominantly onshore markets, without the need for artificial restrictions on the nature of the business that foreign firms can conduct with local institutional investors.

While the main focus should be on cross-border access to institutional investors, in the longer term, it may be possible to develop arrangements for firms to have access to a broad range of retail investors as well.

IOSCO role

IOSCO could play an important role in developing direct cross-border institutional access. In the first place, IOSCO members should make clear the practical basis on which foreign firms can do business with local institutional investors in their country. In many countries, the legal position is simply unclear, as the law does not explicitly address the circumstances under which a foreign firm can do business with a local institutional investor. Firms frequently have to rely on difficult interpretations of when business is regarded as unsolicited business, or the extent to which they can rely on the "intermediation" of a local licensed entity, in order to do business with local institutions.

More significantly, IOSCO should develop an approach under which national regulators can liberalise their markets to allow greater cross-border institutional access. One real risk is that the process will move at the pace of the slowest country involved. This is a particular concern where the chosen approach is based on mutual recognition. In general, rather than waiting for the conclusion of negotiations on reciprocal rights, the emphasis should be on liberalising markets as quickly as possible to benefit the end-users of financial services. Removing the licensing barriers to direct cross-border institutional access would promote efficiencies in capital markets, and should offer significant advantages to both investors and issuers, without undermining the ability of regulators to fulfil their mandates.