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Effective and Efficient Regulation of Cross-Border Capital Markets Transactions

A conceptual framework for identifying areas for international standards, exemption and recognition

1 Introduction

The globalisation of financial markets challenges securities regulators to seek appropriate mechanisms for dealing with cross-border transactions. The "default" position adopted by many regulators is the imposition of national rules. However, many regulators, including those within the EU, which are implementing the Financial Services Action Plan, and the SEC in the US, which is actively discussing selective recognition, recognise that this can be harmful to effective regulation, the cost of doing business and the competitiveness of national markets.

There are, broadly, three ways of alleviating the complexities, costs and burdens imposed by differing national rules (none of which is exclusive):

- *Standardisation:* Development of common approaches or international standards, to reduce the incremental costs of compliance with multiple national rules.
- *Exemption*: Providing exemptions from national rules to foreign firms or issuers where imposing those rules would be disproportionately burdensome.
- *Recognition:* Accepting compliance by a foreign firm or issuer with its home country standards through unilateral or mutual recognition.

The purpose of this paper is to propose for discussion a conceptual framework for determining when determining when each of these approaches is appropriate in improving capital markets regulation and to illustrate this framework by applying it to several examples. This paper has been set at a high level in the hope of achieving directional agreement. In addition to the benefits to markets, such as reduced overall costs, improved access and enhances competition, these approaches will improve regulatory effectiveness in a globalized market by contributing to the development of a community of like-minded supervisory peers through increased regulatory simplicity and transparency and interaction between regulators.

2 Standardisation

International standards are preferable where agreement can realistically be achieved in a reasonable timeframe. Greater standardisation of national rules offers significant advantages for market participants, particularly in easing burdensome requirements, facilitating global, consistent high standards of compliance and reducing costs. It is more likely to be a successful approach in areas of "static" regulation, that is, areas where the rules tend not to change very often and therefore the standardisation between different national rules is unlikely to be disrupted on a regular basis.

The benefits of greater standardisation will also be enhanced if agreement can be reached on simplified, less prescriptive, more 'principles-based' standards. Standards that focus on outcomes are likely to be more flexible in the longer term and to be capable of accommodating differing approaches to compliance across different countries.

A particular example of an area in which standardisation should be pursued is in the area of client categorisation and the definitions of wholesale and retail investors. This is particularly important as it applies to the exemptive rules for "private placements" or "professionals-only" offerings. There is significant scope for standardisation of international rules in this area, building on the example of the EU Prospectus Directive.[1] Effort devoted to opening up the wholesale markets can be expected to bear fruit quickly through enhancing liquidity, providing investors with access to a greater range of products and providing capital raising issuers with access to greater pools of investors. It is likely to be more difficult to reach agreement on means of facilitating cross-border capital raisings aimed at retail investors.

Building on previous IOSCO comments as to the areas of regulation which would benefit from standardisation, the following is a non-exhaustive list of areas where greater standardisation of international securities regulation would be appropriate:

- Classification of counterparties (including with respect to private placements and other offering restrictions);
- Disclosure of large shareholdings;
- Segregation of client assets;
- Transaction reporting requirements;
- Stabilisation rules;
- Client suitability requirements; and
- Prospectus requirements.

Several detailed papers accompanying this paper discuss specific areas for potential international standardisation in considerably more detail. Other topics mentioned above are also of great interest to the industry and papers are in preparation as part of the ongoing dialogue

3 Exemption

However, not all areas of securities regulation are amenable to significantly greater standardisation on a timely basis. In addition, there may still be significant barriers to access to markets even if national rules are similar or the same. In these cases, regulators

[1] The EU Prospectus Directive provides a relatively straightforward framework allowing the placement of securities with a defined class of 'qualified investors' (or with larger denominations), without requiring the filing of a prospectus.

should consider whether it is disproportionately burdensome to impose their rules on foreign firms and foreign securities and whether it is appropriate to exempt foreign firms or securities from compliance with certain aspects of the national rules in question for specified transactions or counterparties. Exemption has the important practical advantage of not requiring a regulator to evaluate a firm's home country licensing and regulatory framework, avoiding the need to make distinctions that are politically sensitive.

For example, local authorisation requirements create significant barriers to cross-border business, because frequently the only way to obtain authorisation locally is to establish a local branch or subsidiary. The model schedule forming part of the Global Securities Industry WTO Initiative to Liberalise Trade in Capital Markets-Related Services (October 2005)[2] sets out a proposed framework under which WTO members would provide exemptions to allow capital markets intermediaries to conduct cross-border business with local institutional and other "qualified investors" without being subject to local authorisation requirements. National regulatory regimes should facilitate the cross-border provision of services by exempting firms from local authorisation requirements where investors are sufficiently expert to protect their own interests.

Again, focusing on wholesale markets can be expected to achieve quicker results, providing local institutional investors with access to a broader array of products and services. 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 host country 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.

The regulation of cross-border activity by financial intermediaries with institutional investors is addressed in more detail in an accompanying paper.

4 Recognition

There are other areas of regulation which would benefit significantly from a move away from national regulation but which are not amenable to significantly greater standardisation on a timely basis. For example, the rules may be insufficiently static in nature to permit meaningful standardisation, but there still may be no overriding policy rationale for the differential between rules in different countries. However, exemption may not be appropriate because policy concerns, such as the involvement of retail customers, suggest a need for greater regulation. Where rules cannot be standardised fully (or are subject only to "minimum" rather than "maximum" harmonisation - that is, they contain common core provisions to which individual regulators may add), mutual or unilateral recognition can provide a "bridge" between differing regimes if a sufficient approximation of rules can be reached.

In addition to the static-dynamic criterion, factors which should inform a decision to seek standardisation or to seek mutual or unilateral recognition again include those mentioned

[2] Available at http://archives2.sifma.org/international/pdf/wtoModel_.pdf

in the IOSCO technical committee's February 2004 Regulation of Remote Cross-Border Financial Intermediaries:

- The nature of the investor (retail versus institutional);
- The nature of the access to a foreign market or entity (directly or through a local intermediary); and
- The type of the security traded (derivative or common stock of a large, well-known seasoned issuer).

Recognition requires national regulators to identify the core outcomes or objectives which their principles and rules are designed to meet. Having done this exercise, it is possible to identify other jurisdictions which respect common principles, even if using rules which may differ considerably in detail. IOSCO has recognised that many jurisdictions have a high degree of congruence in capital markets regulation principles and adopted a representative set of principles. However, recognition should not be based on a legalistic analysis of whether the other regulator has very close or identical rules. Rather, the process should take a broad view of the goals of regulation and should focus on whether those goals can reasonably be expected to be achieved by the other jurisdiction. The IOSCO MMOU, with improvements for enforcement cooperation, could form an important part of any recognition regime.

Provided a national regulator is confident that the principles are sufficiently aligned, it may choose to accept compliance with the foreign rules rather than its own. This approach could be taken unilaterally or based on reciprocity. While both require an evaluation of foreign regulation, some advocate mutual recognition in order to ensure equal footing for a home country's firms that conduct cross-boarder business. Often these benefits may be outweighed by considerations of expediting the process of reform so that it is preferable to focus on unilateral recognition in order to avoid negotiations over the basis of any proposed mutual recognition regime. Attention should be given to strategies, such as temporary pilot programs or industry-initiated processes, to alleviate the political considerations involved in a regulator evaluating a foreign country's regulatory regime. The objective is not a "race to the bottom" to find a lowest common denominator of regulatory standards, but rather consistency across jurisdictions in effective regulation of cross-border business.

Set forth below is a possible framework for such a recognition scheme in respect of:

- capital raisings and distributions of securities;
- the regulation of financial intermediaries; and
- cross-border access to trading venues.

There are a variety of other areas where the need for recognition exists in the context of increasingly globalised and interlinked markets, such as the recognition of credit rating agencies.

5 Capital raising and distributions of securities

The core principle of the regulation of securities is that all investors should have ready access to relevant information in order to make an informed decision whether to invest. This is common to developed markets and certainly forms the base of the SEC's regulation in the US and the EU's Prospectus and Transparency Directives. This applies both when raising capital and when securities remain available for trading by investors in the secondary market.

Beyond this core principle, the points of regulatory convergence which should be present in order to permit recognition are the following:

5.1.1 A prohibition on the offer of securities to the public (i.e. those not falling within private placement rules) unless an offering document (such as a prospectus) has been prepared, approved by the home regulator, and made available to the public before the offer is made.

5.1.2 The offering document must contain in a readily comprehensible form (i) the information necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profits and losses, and prospects of the issuer, or means to access such information and (ii) the rights attaching to the offered securities.

5.1.3 Continuing obligations on an issuer (i) to communicate information to holders and potential holders of its shares in such a way as to avoid the creation or continuation of a false market in such listed equity securities and (ii) to ensure that it treats all holders of the same class of its shares that are in the same position equally in respect of the rights attaching to those shares.

Given the commonality of these principles among many jurisdictions, the addition of further detailed requirements is unnecessary and would unnecessarily impede recognition.

There are considerable challenges with the recognition of Initial Public Offerings by all issuers. However, there are significant achievable benefits in recognition of disclosure standards to permit securities of large, well-known issuers listed in one national market to be traded in another without that host country imposing its own requirements with respect to registration/prospectuses, etc.

Recognition of jurisdictions implementing such principles and therefore permission for issuers to access international pools of liquidity (and investors therefore to access international opportunities to invest in securities) should depend on the following practical steps:

5.1.4 Application of recognition to large, well-known issuers who follow international standards of accounting and disclosure;

5.1.5 Regular reporting to the market through clear and accessible channels;

5.1.6 Existence of a home country liability regime that would protect investors;

5.1.7 An MOU in place between the home and host country regulators which covers powers to share information and conduct and coordinate investigations and enforcement actions.

6 Regulation of financial intermediaries

The key issue here is under what circumstances could broker-dealers or similar intermediaries licensed in their home country provide services to some or all investors in a host country without being licensed or authorized by the host country. In particular, the key issue to be addressed by recognition is the extent to which foreign intermediaries can provide services to retail investors without a licence or authorisation. Institutional investors often have access to the services of foreign intermediaries through overseas offices. In addition, as discussed above, national regulatory regimes should facilitate the cross-border provision of services by exempting foreign firms from local authorisation requirements where investors are sufficiently expert to protect their own interests.

However, such exemptions would still leave issues for retail investors whose ability to achieve the diversification benefits of investment in foreign securities is impeded if host country regulation of foreign intermediaries is excessive. Recognising the authorisation of appropriately regulated foreign intermediaries would enhance the ability of retail investors to purchase foreign securities. This approach also links to some extent with the previous topic; a recognition regime could allow an issuer in (say) the EU to access the capital markets in (say) the US through the appointment of a single broker-dealer in its home jurisdiction. This would save the cost and complexity of needing to appoint intermediaries in each country.

Such a scheme already exists within the EU under the "passporting" directives such as the ISD and MiFID (on the basis of mutual recognition).

Recognition of broker-dealer licenses should depend on the following key principles:

- The authorisation process and prudential regime in the home state of the broker-dealer respecting basic principles that ensure the fitness and propriety of the firm and key individuals within in it;
- The regulator in the home jurisdiction has appropriate capability to supervise the firm and an MOU is in place with the host country, as discussed below; and
- The host country develops disclosure to inform investors that the intermediary is not licensed there and how that affects the rights of the investor against the intermediary.

While this discussion focuses on the imposition of rules on cross-border business and services rather than any change to the regulation of branches, branches of third country firms should be afforded equal treatment with locally incorporated firms. This is often the case, although the exclusion of European branches of non-EU firms from passporting rights within the EU is an example of remaining unequal treatment.

6.1 Conduct of business principles

An important issue is the extent to which a recognised foreign intermediary providing cross-border services to local domestic investors must still comply with the host state's conduct of business rules and other investor protection rules applicable to domestic firms (including rules on asset segregation). A recognised foreign intermediary should be able to provide cross-border services to local domestic investors without complying with the host state's conduct of business rules and other investor protection rules where the intermediary is subject to home state regulation based on the following conduct of business principles, regardless of the details of how they are applied:

6.1.1 Suitability. A requirement to take into account the needs and circumstances of an investor when giving advice.

6.1.2 Best execution. A requirement to provide the best result to a client when executing an order on his behalf.

6.1.3 Conflict management. A requirement to identify conflicts of interest between a firm and its clients and manage those conflicts fairly.

6.1.4 Skill, care and diligence. Requirements on firms to act with due skill care and diligence in the discharge of their regulated functions.

6.1.5 Segregation of assets. Appropriate arrangements under local law to provide for the protection of client assets against the general creditors of the regulated firm.

6.1.6 Information to customers. The requirement to provide customers with appropriate information such as risk warnings, terms of business, or transaction confirms.

6.1.7 Consumer protection. Appropriate arrangements to provide compensation to consumers who suffer loss as a result of rule breaches, such as regulatory capital requirements, funded or unfunded investor protection schemes, or insurance arrangements.

The presence of these general principles should be sufficient to allow for the full recognition of regulated intermediaries and should be fully effective to relieve the foreign broker dealer from compliance with host country rules. These principles already form the basis of conduct of business regulation in many jurisdictions including the US, EU and many Asian countries.

6.2 Regulatory enforcement powers

In addition, it is necessary for the home state regulator to have appropriate capability to enforce its own rules as they apply to the intermediary when doing business with investors in the host state. This means that the conduct of business rules will need to be applied to cross-border as well as purely domestic business. It also means that the regulator must have:

6.2.1 The ability to investigate and enforce breaches of its rules. The range of potential sanctions should be proportionate to the breaches involved and need not be criminal in nature. An ability to reach and publish settlements with firms is acceptable but not essential. The need to refer breaches to a further body for enforcement is acceptable provided that other body meets the requirements of this paragraph.

6.2.2 Due process in reaching its enforcement decisions. Firms should have the right to make representations and put their case in an investigation and for their decision to be taken fairly by an independent tribunal.

6.2.3 The ability to share information with host country and other regulators and to co-operate to achieve enforcement objectives in cross-border situations.

Where these tests are met then it should be possible for a host regulator to be comfortable that the home state has an appropriate regulatory environment.

To the extent that the foreign firm is still required to comply with host state conduct of business or other investor protection rules, the host state regulator will need to be assured that it has appropriate powers to enforce its own rules.

6.3 Incremental approach to implementation

Recognition of financial intermediaries could be adopted in stages depending on the answers to questions such as:

6.3.1 Will it be in respect of all investors or only those with a certain level of sophistication?

6.3.2 Is it limited in terms of the securities/product types which can be traded? For example, would it be limited to securities of issuers in the home jurisdiction of the recognised intermediary?

7 Cross-border access to trading venues

This is, generally, the least regulated of the areas discussed in this paper. Many exchanges and markets already allow for "remote access" by participants from around the world. There are practical constraints arising from the limited inter-operability of national clearing and settlement systems. The details of these constraints fall outside the scope of this paper, however it bears emphasis that there is a significant issue with protectionist regulation in this area and that more rationalized regulation of trading venues has the potential to increase competition and decrease the costs of trading. Regulatory and legislative co-operation to facilitate a supra-national settlement agency and cross-product netting as between different clearing houses should be a priority. The effectiveness of Reg NMS and MiFID results in some similarity of regulation of markets in the US and the EU.

Mutual recognition in this area is an important part of the investor protection framework for mutually recognised securities offerings because once an investor in country A has purchased shares of an issuer which is located in, and has complied with the offering rules of, country B, the A investor should be able to realise his or her investment by appointing a financial intermediary in his own country who can access the market in country B without requiring the exchange in country B to be licensed in country A.

Rather than have separate principles for recognition in this area, it should be an automatic right attaching to recognition of a broker dealer that it be treated on equal terms with domestic firms when seeking access to host country markets and exchanges. A helpful precedent in this connection is the concept, common in Europe, of "remote membership" of exchanges, in which a financial intermediaries licensed in one jurisdiction is permitted to be a member of an exchange in another without additional formalities in the exchange's jurisdiction.