American Bankers Association Securities Association (ABASA)

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)

Swiss Bankers Association (SBA)

Observer: European Banking Federation (EBF)

IOSCO: FACILITATING MUTUAL RECOGNITION AND SUBSTITUTED COMPLIANCE

A Paper by the Transatlantic Coalition on Financial Regulation

NOVEMBER 2012

IOSCO: Facilitating Mutual Recognition and Substituted Compliance

A note on terminology. The members of IOSCO have a range of different entity names. For the sake of simplicity we refer to all IOSCO members below as "member commissions".

1. Introduction

1.1 This paper has been commissioned from Clifford Chance by the Transatlantic Coalition on Financial Regulation (see Appendix 1) and builds on the proposed role for IOSCO in facilitating mutual recognition and substituted compliance as set out in its most recent report, *Inter-jurisdictional Regulatory Recognition: Facilitating Recovery and Streamlining Regulation*, which was published in June 2012. That paper established that conflicting and overlapping regulation of cross-border business placed increasing and unsustainable burdens on regulators as well as financial service providers and their customers. More particularly, it had the effect of generating significant regulatory confusion and needless compliance complexity, as well as reducing investor choice and potentially impairing post-crisis economic and business recovery.

1.2 In the above-referenced paper, we argued that active co-operation between regulators to reduce duplication of effort with regard to the regulation of cross-border business was strongly in the interests of regulators, governments, financial service providers, market infrastructures and consumers of financial services. Achieving such co-operation was dependent on a number of factors, including the execution of comprehensive memoranda of understanding between authorities, to facilitate timely sharing of information and full co-operation in the area of supervision and enforcement and a high degree of compatibility between the regulatory frameworks of co-operating authorities. However, it seems clear that, particularly in this climate of major regulatory change, the authorities have neither then resources nor the time to undertake the kind of analysis of the regulatory frameworks of other jurisdictions which are necessary in order to establish the pre-condition of regulatory compatibility.

1.3 In our last paper, we emphasised that IOSCO had produced several sets of regulatory Principles designed to benchmark the quality of regulation applicable to regulatory authorities and market infrastructures and that these have been developed with the support of the member commissions of IOSCO. These extend beyond the narrow field of securities intermediary regulation, and address in detail both product-related issues and issues arising out of payments, settlement and clearing activities. While it is recognised that, of themselves, they may not be sufficient for the purposes of establishing regulatory compatibility and that they do not cover supervision and enforcement, it does seem that IOSCO is the obvious and only candidate for the role of mentoring and promoting international mutual recognition. In this context, it is noteworthy that IOSCO has

embarked on a programme of establishing where there are areas of regulatory weakness amongst regulators in some of the emerging and newly-emerged economies.

1.4 The benefits of regulatory recognition and exemptive relief are precisely those articulated by IOSCO in its core Principles - to protect investors, ensure that markets are fair, transparent and efficient, and reduce systemic risk. We believe that the interests of investors are best protected by measures which enable entities subject to equivalent regulation to offer services to investors; that reducing barriers to cross-border activities is the best way of ensuring that international markets are fair, transparent and efficient (and competitive); and that unnecessary obstacles to cross-border offerings of services increase national interdependencies and lead to an increase in global systemic risk. To this last point, it is now generally accepted that one of the gravest risks to the global financial system is the interdependence between national banks and the financial stability of their home governments. The securities markets does not have this issue precisely because they are global, international markets which are not subject to national dependence. It is important to retain and improve this characteristic.

2. Proposal

2.1 In broad terms, we believe that IOSCO is the only international organisation capable of facilitating the kind of analysis necessary to achieve regulatory recognition and energise the dialogue in delivering substituted compliance where there is regulatory compatibility between states. While there is nothing to prevent any two regulatory authorities agreeing between themselves that their rules are sufficiently compatible to accommodate substituted compliance, either unilaterally or bilaterally, a plethora of such bilateral arrangements would generate different standards in compatibility, whereas if IOSCO were to be the forum for such dialogues, this would be a significant advance in delivering an internationally-acceptable 'benchmark' for measuring compatibility and avoid the risk of a multiplicity of bilateral arrangements based on divergent determinations of equivalence. This risk of divergence is a real risk - at its simplest, if country A believes that its rules are equivalent to those of countries B and C, but country B disagrees that its rules are equivalent to those of country C, the position may be made worse rather than better.

2.2 In this context, it is noteworthy that little progress has been made in the past decade in establishing substituted compliance. This is probably largely due to the extent and range of the post-crisis regulatory repair programme, but also in good part to the lack of capacity to commit the amount of resource and time necessary to undertake comprehensive regulatory analysis of the rules in other jurisdictions. Further, it is recognised that once a regulatory authority has begun a process of accommodating substituted compliance in one jurisdiction, it will come under increasing pressure to

initiate similar negotiations with a number of jurisdictions – adding to the resource problem.

We believe that, if the process of regulatory analysis and setting standards of comparability were to be undertaken collectively and under the auspices and sponsorship of IOSCO, some of the difficulties of individual bilateral discussions would be overcome, including the tendency of each and every regulator to regard its own rules and processes as the gold standard against which others are measured. In our view, the advantages are self-evident, namely:

- The proven ability of IOSCO to secure consensus amongst its constituent member commissions
- The existence of the IOSCO Principles for Securities Regulation and its standards set for market infrastructures, together with its Multilateral Memorandum of Understanding (notwithstanding that it may need to be extended), provide a foundation/starting-point which is held in common already by its member commissions
- The role of IOSCO as the only substantial international 'college' of regulatory authorities and commissions and its capacity to access a wide range of expertise relating to individual national regulatory systems
- The benefits of regulatory recognition and substituted compliance are wholly consistent with the role and objectives of IOSCO, particularly in the area of harmonising regulatory standards.

2.3 By publishing and promulgating its standards, IOSCO has recognised that equivalent outcomes can be delivered by differing administrative and legislative techniques. Furthermore, with the publication of the IOSCO methodology for peer- or self-assessment of compliance with these Principles, a methodology for regulatory assessment already exists. The Coalition's proposition is therefore a natural evolution of the existing role of IOSCO.

3. Methodology

3.1 There are two major components of the determination mechanism put forward by the Coalition. The first is as to how such determinations should be commenced, and the second is as to how they should be made.

3.2 As to commencement, the initiative for an IOSCO determination should come from the member commissions involved, albeit encouraged and mentored by IOSCO. Of course, in some jurisdictions, the making of such determinations is not vested in the member

commission itself, but in its national government – however, it is anticipated that, where there is an IOSCO finding of regulatory equivalence, the independence and standing of IOSCO in these matters should enable them to influence national governments to act on such findings of equivalence and authorise the relevant member commission to facilitate substituted compliance. The fact that national governments are not themselves involved in IOSCO should not be an insuperable barrier.

3.3 Where a number of member commissions are involved in the process of analysis, a multilateral determination should be capable of being made relatively easily.

3.4 The process involved would be broadly equivalent to a peer review. Each participating member commission would, in the first instance, produce a reconciliation of its own laws and regulations, in each case reconciling them to the IOSCO Principles. The mechanisms used in these comparisons should be based on the mechanisms set out in the IOSCO *Interpretative Texts And Methodology For Assessing Implementation Of The Iosco Objectives And Principles Of Securities Regulation.* The resulting reconciliations of the different participating member commissions would then be compared. Any discrepancies would be discussed within an IOSCO forum. This process would be procedurally similar to mediation, with IOSCO playing a facilitating role in discussions which would ultimately be conducted between the member commissions themselves.

3.5 It should be noted that the essence of this proposal is not to confer powers on IOSCO, but to enable it to act as a facilitator of agreements, a register of conclusions and, where desirable, an intermediary between member commissions.

3.6 One of the more important aspects of the proposal is that the process should be designed to be multilateral. The reason for commencing with a reconciliation to IOSCO Principles is that this should enable multiple different member commissions to participate in the same determination. Once two or three jurisdictions have established sufficient common ground between themselves to determine that a finding of substituted compliance could be made. We believe that that finding would provide a robust bench mark against which multiple other jurisdictions could increasingly be measured. Thus, what may have started as a bilateral discussion could conclude with a multilateral agreement.

3.7 The process would involve each member commission undertaking an analysis based on the IOSCO Principle(s) concerned. This would then be capable of being easily compared with other submissions, since all of these would be compared against a common benchmark. Comparability would be facilitated by such a structure.

3.8 It is important to emphasize that we are not suggesting that IOSCO should have any formal power to decide issues relating to whether or not systems are in fact equivalent. Ultimately the only entities which can be charged with determining substituted

compliance are the relevant member commissions themselves (along with, as may be relevant, their governments).

3.9 It is also important to note that a finding of acceptable substituted compliance by IOSCO would not necessarily be equivalent to any mandate on any relevant member commissions to accept cross-border activity from the jurisdiction concerned. We accept that a finding that rules are equivalent is not the same as a finding that the supervisory system or enforcement practice in a given jurisdiction is equivalent. However, without a consensual acceptance of the equivalence of rules, a finding of equivalence of outcomes is not a practical proposition. Thus an overall determination of equivalence by IOSCO, while credible and persuasive, would not of itself be legally binding. It would, however, play a key role in establishing regulatory recognition.

3.10 One important point which requires to be addressed here is that the IOSCO Objectives and Principles were not developed to be used for a "pass" or "fail" grading. They are recognized to be aspirational. Consequently it may well be that a particular member commission may have elected, for good national reasons, to have implemented a principle in an exceptional way. However, issues of this kind would be taken into account in the self-assessment performed by IOSCO members, and the peer group review process which may also be undertaken. However, the work that has already been done demonstrates that any particular Principle may be able to be satisfied in variety of ways and, indeed, that may reflect the legal and other circumstances of a jurisdiction. This is precisely why we believe that benchmarking systems against the IOSCO Principles is more likely to give a useful, independent readout of the comparability of their outcomes than simply comparing them in detail bilaterally with each other.

4. Scope

4.1 IOSCO has produced considerably more than the overarching Principles for Securities Regulation, and there are a number of other areas in which IOSCO guidelines exist for the appropriate regulation and regulatory treatment for certain types of products and services. These range from principles for liquidity risk management in collective investment schemes through to principles for the supervision of financial conglomerates. It would be quite possible to use many of these sets of specific principles as bases for substituted compliance, and it may well be that it might be possible to make substantial early progress by focusing on some of these.

4.2 However, the danger is that if the process considered above is expanded to cover every set of principles issued by IOSCO, it may become too detailed for practical use, since assessing full compliance with every IOSCO principle in any area might be an unachievable goal for any regulatory system. We therefore consider it important to assert that we are not suggesting at this stage that member commissions should be able to object

to a finding of compliance with the principles by raising non-compliance with some other IOSCO-endorsed policy. However, we can see no reason why such policies should not form the basis for findings of substituted compliance amongst specific groups of member commissions.

5. Process

5.1 The process would commence with an initial proposal being made by one or more member commissions and, of course, may be prompted and proposed by IOSCO. In such circumstances, it is likely that any initial proposal of this nature would be bilateral or even trilateral. However once a bilateral standard has been attained, other member commissions should be encouraged to join in the process with a view to establishing a multilateral 'benchmark', which could lead to regulatory recognition and, as a result, substituted compliance.

5.2 The starting point for each process will be the self-analysis performed by the member commissions themselves as to whether or not they are in compliance with the relevant IOSCO core principle(s). Where two member commissions are agreed that their rules satisfy the relevant IOSCO principle(s), it should be accepted that there is a common foundation capable of leading to mutual regulatory recognition. At the same time, it is recognised that the process of analysis will have to go beyond the Principles, particularly in the area of supervision and enforcement. It will, of course, be open to other member commissions to challenge any such finding and, in such an event, should be required to produce a statement of reasons demonstrating why, in its view, the relevant provisions of the law or regulation of the jurisdiction of the other member commissions does not achieve this end. It would then be the role of IOSCO to sponsor a dialogue between the relevant member commissions, establish the validity or otherwise of the objections raised, and to identify whether there are appropriate amendments which could be made to the rules of the member commission concerned which would be sufficient to remedy the challenge. The focus of IOSCO in this regard should be extended to cover supervision and enforcement as well as regulatory policy and rules' compatibility. In other words, IOSCO would perform the role of an arbitrator.

5.3 A finding of regulatory compatibility should lead automatically to a review of the extent to which the relevant home member commission can accommodate and recognise compliance with the relevant host-state member commission(s), i.e. the substitution of compliance with its rules with those of the rules of the host member state, and the extent to which parallel forms of exemptive relief can be accommodated between the relevant member commissions.

5.4 In addition to the issue of substituted compliance, it is recognised that, in certain operational areas, there may be significant differences in resources, capability and

expertise in the area of supervision and enforcement, which may mean that, if investors carrying on cross-border business are to be effectively protected, the degree of operational reliance placed by a home member state member commission on the supervision and enforcement capability of a host member state member commission may have to be differentiated to some extent, but this could be accommodated within individual bilateral/multilateral annexes as part of an extended IOSCO *Memorandum of Understanding*, which would go beyond the scope of the existing MMOU.

5.5 Regulatory cooperation and the growing rights of cross-border market and customer access have not always been aligned with the needs of customers and their intermediaries. For this reason, we believe that IOSCO should provide an opportunity for the financial services sector, i.e. financial service providers and consumers and market infrastructures, to put forward their own proposals, insofar as they are key stakeholders in the outcome of regulatory recognition and should therefore have an opportunity to put forward their views and for those views to be properly taken into account.

6. Conclusion

6.1 Finally, it is important to stress that the primary purpose of this proposal is to produce a mechanism within which the demands on the resources of member commissions are reduced and to establish a coherent framework of regulation for the carrying on of cross-border business. We accept entirely that some securities regulators may currently be under-resourced and overstretched in terms of developing the post-crisis regulatory repair programme and meeting the regulatory expectations placed upon them. We are equally aware that a bilateral process structured to assess the comparability of differing regulatory requirements is resource-intensive for individual authorities in terms of undertaking the analysis, monitoring changes and observing and monitoring observance of what could be a plethora of differentiated memoranda of understanding.

6.2 Our proposal addresses this in a number of distinct ways, namely:

(a) By basing the initial assessment on the regulatory standards already set by IOSCO through its Principles, it is using standards which have already been agreed by its member commissions

(b) Because the work will be undertaken under the auspices of IOSCO, the prospect of establishing a consensual international ‘benchmark’ instead of a set of differentiated bilateral arrangements (which would create real on-the-ground problems for infrastructures and intermediaries in terms of regulatory compliance) would be enhanced significantly

(c) A collective approach should reduce the resource burden for individual regulatory authorities significantly

(d) IOSCO endorsement of the outcome, while not legally binding on national governments, should be both credible and persuasive.

(e) IOSCO is clearly the only international entity that is capable of assuming this responsibility and is also the only entity with access to the largest pool of cross-border regulatory expertise in all the relevant jurisdictions.

APPENDIX 1

TRANSATLANTIC COALITION ON FINANCIAL REGULATION

Briefing Note

TRANSATLANTIC COALITION ON FINANCIAL REGULATION

1. Introduction

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 (now renamed the Transatlantic 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 Banking Federation (SBF)

European Banking Federation (EBF) *[observer]*

Their purpose, 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. A more coherently regulated and open transatlantic financial services marketplace will reduce legal risk and compliance complexity, enhance efficiency, choice and access, clarify applicable investor protection standards and reduce costs for providers and consumers of financial services and regulatory authorities.

2. The Coalition's Objectives

The objectives of the Coalition are:

(a) to encourage and expedite wider acceptance of *regulatory recognition* and *exemptive relief* (whether unilateral, bilateral or multilateral) as accepted international practice;

(b) 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.

3. Previous work

In furtherance of those objectives, the Coalition launched in 2005 a major two-volume study "The Transatlantic dialogue in financial services: The case for regulatory simplification and trading efficiency[1]" in London and Washington. The Report set out the case for regulatory recognition and included a legal analysis which compared the then applicable US and EU legislative and regulatory requirements (and related Swiss rules).

Noting the positive reaction to its 2005 Report, the Coalition issued a second report on 1st April 2008, *"Mutual Recognition, Exemptive Relief and "targeted" Rules' Standardisation: The Basis for Regulatory Modernisation"*[2], which 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*; set out the key criteria for establishing a durable basis for regulatory recognition; and identified industry priorities for "targeted" rules' convergence.

4. Next steps

In 2008, the task of developing a more efficient and open transatlantic market became subordinated to the understandable priority objective of implementing changes to regulatory structures, rules and practices to address the lessons of the financial crisis. Unfortunately, the post-crisis regulatory repair programme has incorporated, in certain areas, elements of protectionism and extraterritoriality, which undermines the capacity to deliver early post-crisis economic recovery and the need for coherently-regulated and more open markets.

As a result, the Coalition has commissioned the international law firm, Clifford Chance, to produce a report on the post-crisis benefits of regulatory recognition and the need for an early resumption of the transatlantic dialogue in financial markets and services. The Coalition intends to publish the Report in June 2012.

For more information on the Coalition and its work, please contact the Coalition Secretariat, which is based at the offices of the FOA:

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[1] 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.

[2] http://www.foa.co.uk/publications/eu-us%20report-%20mar08.pdf