February 23, 2015

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28006, Madrid
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Re: Task Force on Cross-Border Regulation, CR09/2014

Ladies and Gentlemen:

Better Markets[1] appreciates the opportunity to comment on the above-captioned consultative document (the "Consultative Document") of the International Organization of Securities Commissions ("IOSCO").

**INTRODUCTION AND SUMMARY OF COMMENTS**

On November 25, 2014, IOSCO released a consultation report from its Task Force on Cross-Border Regulation ("Task Force"). The Consultation Document "summarizes and analyzes the cross-border regulatory tools described by survey respondents broadly in order to form a more comprehensive understanding of these tools that can serve as the basis for a Toolkit."[2] Thirty-seven "IOSCO members participated in the survey, of which 21 were members from the Growth and Emerging Markets Committee"[3] and, by deduction, 16 were members from advanced countries. "The survey elicited information on tools that respondents have adopted, planned to adopt, or are aware of, to address cross-border regulatory issues across activities involving, among others, market intermediaries, securities exchanges and markets, CIS [Collective Investment Schemes], and financial market infrastructure."[4]

The Task Force requested comments regarding all interested persons' experience with, and understanding of, the cross-border securities markets as characterized in the report. It further indicated that "[a]fter the conclusion of the consultation period, the Task

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1 Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking processes associated with domestic and international financial reform.
2 *Consultative Document,* at 6.
3 *Id.*, at 5.
4 *Id.*, at 6.

Force will review and analyze the responses and feedback received. The key findings from this exercise will be used to form the basis of the final report and may provide important input and ideas to the IOSCO 2020 Working Group which is tasked to identify and develop IOSCO's priorities over the next five years."[5]

The IOSCO Task Force efforts to develop an effective cross-border regulation regime are commendable. However, this comment letter questions the fundamental feasibility of the approach elected by the IOSCO in addressing securities and derivatives cross-border coordination, and it identifies three critical elements missing from the framework proposed by IOSCO. The comment letter draws examples from the U.S regulatory regime, as the largest financial market, to demonstrate the limits of the narrow and insular approach to securities and derivatives cross-border coordination proposed by the Task Force:

1. Regulatory interconnectedness – The Task Force surveyed IOSCO member securities regulators in the development of the cross-border regulation framework. However, efficient and effective cross-border coordination in the area of securities and derivatives requires involvement of all responsible market and prudential regulators. The Crisis Management Groups of the Financial Stability Board offer a viable model of cross-border coordination that brings together all interested parties.

2. Scope – The Task Force focuses on a narrow and insular definition of securities and derivatives and does not consider the spillovers and interconnections of those instruments with other financial activities and products. For example, the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and Exchange of Information that. the Task Force relies on for this work is defined by IOSCO as a tool for "compliance with and enforcing securities and derivatives laws and regulations"[6] and does not consider the essential elements of capital and liquidity regulation as well as financial stability regulatory measures.

3. Financial Market Infrastructures ("FMIs") – The Task Force gives no consideration to the impact of FMIs on the cross-border coordination framework. Meaningful cross-border cooperation between market and prudential regulators on the regulation of FMIs is essential for effective cross-border coordination in the area of securities and derivatives. The infrastructure supporting the securities and derivatives markets cannot be treated in isolation from those markets.

**BACKGROUND**

In June 2013, IOSCO established the Task Force "to examine, consider and analyze cross-border regulatory issues and tools."[7] IOSCO noted that "the work of the Task Force aims to assist policy makers and regulators in addressing the challenges they face in

[5] *Consultative Document,* at 47.
[6] *Id.*, at 3.
[7] *Id.*, 2.

protecting investors, maintaining market quality, and reducing systemic risk."[8] The Task Force is composed of 22 market regulators.[9] IOSCO explains that "in today's global securities markets, financial activities often cross national borders. As a result of these developments and their supervisory responsibilities over markets, trading, products and market participants, securities regulators often have regulatory interests that extend beyond their borders."[10] The Task Force defines securities markets to include "equities, debt and derivatives."[11] IOSCO gave the Task Force a mandate:

1. "To develop a cross-border regulatory toolkit (Toolkit), containing common terminology, of regulatory options for use by IOSCO members."[12]

2. "Where appropriate, to lay a foundation for the development of guidance on the coordinated use of the Toolkit to help IOSCO members consider how a particular tool can be used to achieve IOSCO's three regulatory goals: protection of investors, ensuring that markets are fair, efficient and transparent, and reduction of systemic risk."[13]

The Task Force survey identified three tools to regulate cross-border securities market activities:

1. National treatment – Foreign persons, entities, and products are generally treated in the same manner as domestic ones regardless of the foreign regulatory regime.

2. Recognition – Upon assessment, the domestic regulator recognizes that the foreign regulatory regime is sufficiently comparable to the domestic regime to allow for reliance on the other jurisdiction's regulatory regime.

3. Passporting – An international treaty or similar legal instrument or agreement on a common set of rules which permits market access may be necessary.[14]

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8 *Id.*

9 The members of the Task Force are the Australian Securities and investment Commission (Australia), Comissão de Valores Mobiliários (Brazil), British Columbia Securities Commission (British Columbia, Canada), Financial Supervisory Commission (Chinese Taipei), European Securities and Markets Authority (European Union), Autorité des marches financiers (France), Bundesanstalt für Finanzdienstleistungsaufshicht (Germany), Securities and Futures Commission (Hong Kong), Securities and Exchange Board of India (India), Commissione Nazionale per le Societá e la Borsa (Italy), Financial Service Agency (Japan), Securities Commission (Malaysia), Comisión Nacional Bancaria y de Valores (Mexico), Authority for the Financial Markets (Netherlands), Ontario Securities Commission (Ontario, Canada), Autorité des marches financiers (Québec, Canada), Monetary Authority of Singapore (Singapore), Comisión Nacional del Mercado de Valores (Spain), Financial Market Supervisory Authority (Switzerland), Financial Conduct Authority (United Kingdom), US Commodity Futures Trading Commission (United States), and US Securities and Exchange Commission (United States).

10 *Consultative Document*, at 1.

11 *Id.*

12 *Id.*, at 2.

13 *Id.*

14 *Id.*, at 8.

**COMMENTS**

1. The cross-border regulatory dialogue on securities and derivatives cross-border regulation must include financial stability, prudential, and market regulators who have responsibilities for various aspects of securities and derivatives markets, products, and participants.

Efficient and effective cross-border coordination in the area of securities and derivatives requires involvement of all responsible market and prudential regulators in the dialogue. A focus on the narrow interpretation of securities and derivatives markets and an effort to develop cross-border coordination tools in isolation from other financial markets with which securities and derivatives markets are closely linked risk promoting a balkanized, inefficient and counterproductive solution to cross-border coordination.

For example, in the U.S. the following agencies and forums have certain responsibilities for regulation and regulatory coordination of securities and derivatives activities, products, and/or institutions:

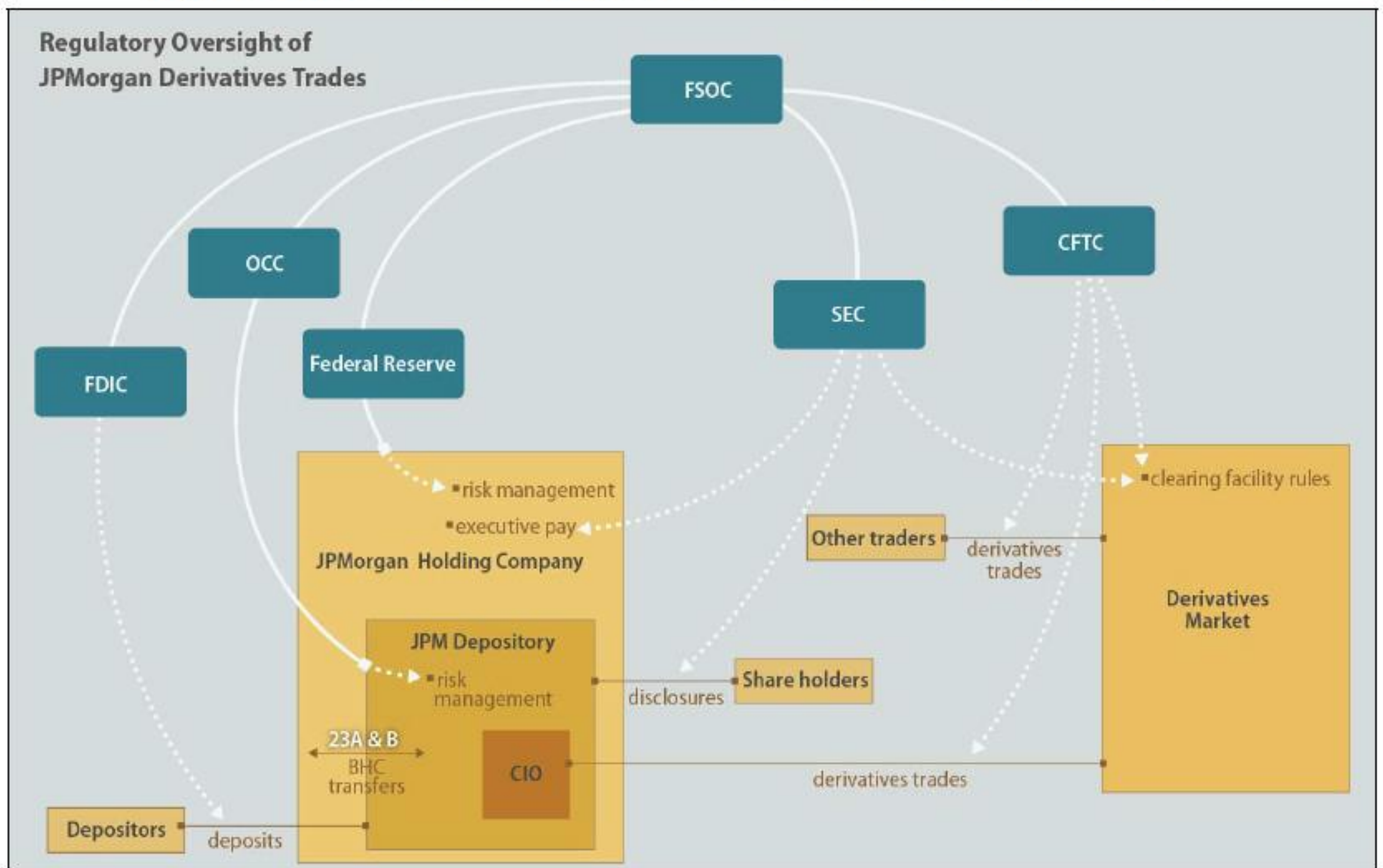
- Financial Stability Oversight Council;
- Federal Deposit Insurance Corporation;
- Board of the Governors of the Federal Reserve System;
- Office of Comptroller of the Currency;
- Securities and Exchange Commission;
- Commodities Futures Trading Commission;
- National Credit Union Administration;
- Federal Housing Finance Agency;
- Federal Financial Institutions Examinations Council; and
- President’s Working Group on Capital Markets.

The Congressional Research Service report prepared for Members and Committees of the U.S. Congress, entitled “Who Regulates Whom and How? An Overview of U.S. Financial Regulatory Policy for Banking and Securities Markets,” explains that,

> A specific event in the financial industry is often regulated by multiple agencies because firms subject to institution-based regulation often conduct financial transactions that are subject to activity-based regulation. JPMorgan’s losses in derivatives markets in 2012 may provide a helpful illustration. JPMorgan’s depository bank subsidiary has a risk management unit called CIO. This unit had significant losses on trades related to complex derivatives (called the London Whale trades at the time), which JPMorgan asserted were designed to guard against systemic risk. When revelations of the losses became public, and people wanted to know who JPMorgan’s regulator was, the answer was that there were many regulators related to JPMorgan’s London Whale trades, depending upon which aspect of the event a person was interested in.

The regulatory policy areas of agencies related to JPMorgan's derivatives trades are presented in Figure 1. As a bank, JPMorgan's risk management was subject to prudential regulation by the OCC [Office of the Comptroller of the Currency] at the depository level, and by the Federal Reserve on a consolidated basis at the holding company level. As a public company, JPMorgan's disclosures of the trades to its stockholders were regulated by the SEC. As a participant in derivatives markets, JPMorgan's transactions were subject to CFTC regulation. As an insured depository institution, JPMorgan's safety and soundness was also subject to the FDIC [Federal Deposit Insurance Corporation].[15]

**Figure 1. An Example of Regulation of JPMorgan Derivatives Trades**




**Source:** CRS.

The Crisis Management Groups of the Financial Stability Board offer a viable model for an international forum where cross-border coordination on multi-sector securities and

[15] Congressional Research Service, *Who Regulates Whom and How? An Overview of U.S. Financial Regulatory Policy for Banking and Securities Markets* (January 30, 2015), at 3, *available at* http://digitalcommons.ilr.cornell.edu/key_workplace/1148.

derivatives regulation may take place. Such groups work with major participants on cross-border resolution and recovery activities, which include products and participants from the securities and derivatives world. The presence of financial stability, prudential, and market regulators in the FSB makes it an appropriate model for the support of such coordination.

2. Cross-border regulation cannot and should not be focused on narrowly defined asset classes, types of products or participants, but instead must address cross-border financial regulation in an inclusive and holistic manner to avoid regulatory arbitrage among financial products and participants.

The Task Force focuses on a narrow definition of securities and derivatives and does not consider the spillovers and interconnectedness of those instruments with other financial activities and products. Professors Allen and Herring explain the origin of the U.S. tradition of narrow securities regulation in their paper "Banking Regulation versus Securities Market Regulation,"

> The basic framework of securities regulation grew out of a desire to protect consumers. Arguably it plays a more important role in terms of enhancing the efficiency of financial markets. Securities regulation has placed a very limited emphasis on the prevention of systemic risk. In the United States, securities firms are not subject to the consolidated prudential supervision focused on the soundness of the institution as a whole that characterizes bank regulation. Instead, the emphasis is on protecting some of the functions that the securities firm performs.[16]

Professors Allen and Herring state that four trends in the international financial system suggest that securities firms pose a systemic threat to the financial system and that outdated narrow-focused securities regulation is inappropriate and harmful. The four trends identified by the authors to support their conclusion are:

1. "Leading securities firms have become increasingly international. Not only do they participate in securities markets around-the-clock, around the globe, but also they operate through a complex structure of affiliates in many different countries with differing bankruptcy regimes."[17]

2. "Securities firms have increasingly affiliated with commercial banks and/or insurance firms to form financial conglomerates."[18]

3. "Securities firms and banks have consolidated to form lager and large entities."[19]

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[16] Franklin Allen and Richard Herring, *Banking Regulation versus Securities Market Regulation*, THE WHARTON SCHOOL (July 11, 2001), at 26.
[17] *Id.*, at 35.
[18] *Id.*
[19] *Id*.

4. "The largest firms are becoming increasingly involved in global trading activities, particular over-the-counter (OTC) derivatives."[20]

The interconnectedness and interdependencies of prudential and market regulation in the areas of securities and derivatives are well illustrated by the consolidated view of banking and securities regulatory policies developed by the Congressional Research Service:[21]

| **Types of Banking Regulatory Policies** | **Types of Securities Regulatory Policies** |
|---|---|
| Asset Restrictions | Disclosure Standards |
| Capital Adequacy | Registration Requirements |
| Conduct of Business Rules | Manipulation Prohibition |
| Competition Policy (Anti-Trust) | Insider Trading Prohibition |
| Conflict of Interest Rules | Takeover Rules |
| Investment Requirements | Protection of Minority Shareholders |
| Customer Suitability Rules | Investment Management Rules |
| Deposit Insurance | |
| Fit and Proper Entry Tests | |
| Limits on Interest on Deposits | |
| Limits on Interest on Loans | |
| Liquidity Requirements | |
| Reporting Large Transactions | |
| Reserve Requirements | |
| Restrictions on Geographic Reach | |
| Restrictions on Services and Product Lines | |

As the London Whale incident demonstrated, events in the securities and derivatives markets have a broad impact on other financial markets. The financial crisis of 2007-09 demonstrated even more powerfully that ignoring the financial stability and macro-prudential aspects of derivatives instruments is a risky approach with potentially catastrophic consequences. The Task Force is currently following a narrow approach of cross-border regulation that needs to be updated to reflect the likely spillover and interconnectedness of securities and derivatives markets with other financial markets and participants. Any cross-border coordination discussion should involve financial stability, prudential and market regulators to ensure that regulatory outcomes address broad societal needs and not the narrow priorities of a particular type of a regulator.

3. <u>Meaningful cross-border coordination of market and prudential regulators on regulation of FMIs is essential for effective cross-border coordination in the area of securities and derivatives.</u>

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[20] *Id.*, at 36.

[21] Congressional Research Service, *Who Regulates Whom and How? An Overview of U.S. Financial Regulatory Policy for Banking and Securities Markets* (January 30, 2015), at 4.

Meaningful cross-border coordination of market and prudential regulators with respect to the regulation of FMIs is essential for effective cross-border coordination in the area of securities and derivatives. The infrastructure of the securities and derivatives markets cannot be treated in isolation from those markets. Known as financial market utilities ("FMUs") in the U.S., FMIs are "multilateral systems that provide the infrastructure for transferring, clearing, and settling payments, securities, and other financial transactions among financial institutions or between financial institutions and the system. In cases where, among other things, a failure or a disruption in the functioning of an FMU could create, or increase, the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the U.S. financial system, the FMU may be designated as systemically important by the Financial Stability Oversight Council. To date, the Council has designated the following FMUs as systemically important. The Supervisory Agency (i.e. the Federal agency that has primary jurisdiction over a designated FMU under Federal banking, securities, or commodity futures laws) is indicated in parentheses:

- The Clearing House Payments Company, L.L.C., on the basis of its role as operator of the Clearing House Interbank Payments System - (Board);
- CLS Bank International - (Board);
- Chicago Mercantile Exchange, Inc. - (Commodity Futures Trading Commission (CFTC));
- The Depository Trust Company - (Securities and Exchange Commission (SEC));
- Fixed Income Clearing Corporation - (SEC);
- ICE Clear Credit L.L.C. - (CFTC);
- National Securities Clearing Corporation - (SEC); and
- The Options Clearing Corporation - (SEC).

"The designation of an FMU as systemically important by the Council subjects the designated FMU to the requirements of Title VIII of the Dodd-Frank Act. For example, section 805(a) authorizes the Board of Governors, the Commodity Futures Trading Commission (''CFTC''), and the Securities and Exchange Commission (''SEC''), in consultation with the Council and one or more Supervisory Agencies and taking into consideration relevant international standards and existing prudential requirements, to prescribe risk management standards governing the operations related to the payment, clearing, and settlement activities of systemically important FMUs."[22]

The regulatory treatment of central counterparties ("CCPs") offers an illustrative example of why securities and derivatives markets have a broad impact on the financial stability and functioning of other markets. The failure of a CCP or even a major stress condition in a CCP will likely have a material impact on financial stability not only in the U.S. but globally and will require significant intervention by prudential regulators (in particular the Fed and the FDIC) to mitigate the negative impact of the CCP's failure.

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[22] Financial Stability Oversight Council, *Authority to Designate Financial Market Utilities as Systemically Important, Final Rule*, 76 Fed. Reg. 44763 (July 27, 2011).

Those concerns were outlined by the IMF in their Global Financial Stability Report:

> CCPs should have appropriate risk modeling capabilities, be built on solid multilayered financial resource that are reinforced by financially strong CM [Clearing Members], have clear and legally enforceable layers of protection or financial support for covering losses given a CM default, and have developed contingency and crisis management plans, including for emergency liquidity support. Moreover, given that CCPs are active internationally, given the global nature of the OTC derivatives market, this requires close cross-border coordination or regulatory and supervisory frameworks. This would help to avoid regulatory arbitrage and mitigate systemic risk and adverse spillover across countries. The legal and regulatory treatment of CCPs should be clarified on issues such as their legal form and charters, supervisory regime, risk management framework, insolvency regime, and emergency resolution process.[23]

CCPs have systemic risk implications. Moreover, their members are regulated by prudential regulators to ensure adequate capital reserves, liquidity, limits on leverage, recovery and resolution tools. Therefore, prudential regulators should be actively and meaningfully involved in any regulatory discussion involving financial market infrastructures supporting securities and derivatives markets. Absent this involvement, there is a risk of a regulatory conflict of interest emerging, where market regulators focus on day-to-day oversight of institutions such as CCPs while prudential regulators face the capital, liquidity and resolution challenges of those institutions but have limited ability to affect the approach to risk management for those institutions.

## CONCLUSION

Cross-border financial regulation should adopt a holistic, cross-sector approach where financial stability, prudential, and market regulators are equally involved to achieve a sound outcome for the economy overall and not just a narrow financial sector. A narrow sector-focused approach to financial regulation proved to be ineffective and damaging in the financial crisis of 2007-09.

To ensure that the modern regulatory framework addresses the realities of the modern financial markets, a holistic approach to the cross-border regulatory framework must be adopted. Consequently, this comment letter questions the soundness of the approach elected by the IOSCO in addressing securities and derivatives cross-border regulatory coordination and identifies three critical elements missing from the framework proposed by IOSCO:

1. Regulatory interconnectedness – Efficient and effective cross-border coordination in the area of securities and derivatives requires involvement of all

[23] International Monetary Fund, *Global Financial Stability Report: Making Over-the-counter derivatives safer: the role of central counterparties* (April 2010), at 15.

the responsible market and prudential regulators in the regulatory dialogue. Crisis Management Groups of the Financial Stability Board offer a viable model of cross-border coordination that brings together all interested parties.

2. Scope – The Task Force focuses on a narrow and insular definition of securities and derivatives and does not consider the spillovers and interconnections of those instruments with other financial activities and products.

3. Financial Market Infrastructures – Meaningful cross-border cooperation between market and prudential regulators on the regulation of FMIs is essential for effective cross-border coordination in the area of securities and derivatives. The infrastructure supporting the securities and derivatives markets cannot be treated in isolation from those markets.

We hope these comments are helpful.

Sincerely,

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