Alternative Investment Management Association

Mr Ashley Alder
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Securities and Futures Commission
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By email: xbr@sfc.hk

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Dear Ashley,

AIMA Submission: IOSCO Task Force on Cross Border Regulation

The Alternative Investment Management Association (AIMA)[1] greatly appreciates the ability to participate in the public hearings organised by the IOSCO Task Force on Cross-Border Regulation. In this submission, we set out our views on this topic, including the role that we see IOSCO playing.

AIMA represents participants in the global hedge fund industry, many of whom operate in multiple jurisdictions, entering into a board range of transactions. The way in which individual jurisdictions approach the regulation of cross-border transactions or entities that operate across national borders has a significant bearing on the ability of our members to access different markets and regions. Ultimately, coherent and consistent cross-border regulation promotes financial integration and fosters liquidity across a broad range of global markets.

In our submission, we explain:

- The diverse ways in which our member firms react to cross-border conflict, which can, in the extreme, entail exiting particular markets or discontinuing certain lines of business.
- The value – and also shortcomings – of existing relief mechanisms, notably substituted compliance, and the propensity for the conditions attached to relief to become a block to its widespread application.
- The role that IOSCO could play in ensuring that overlap and conflict between rules is minimized as far as possible, by: developing standards governing the scope of rules in different contexts; giving due consideration to cross-border issues in the development of sector-specific standards; and by developing formal hierarchies to specify which jurisdiction's rules should apply in a given situation.
- The importance of comprehensive information exchange mechanisms, in order to ensure that authorities have the information that will give them confidence that their supervisory objectives are being met, whilst providing a genuinely global view of systemic risk.

[1] As the global hedge fund association, the Alternative Investment Management Association has over 1,400 corporate members (with over 7,000 individual contacts) worldwide, based in over 50 countries. Members include hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting firms, investors, fund administrator and independent fund directors.

- The need for a new forum at IOSCO level in which members could identify, discuss and resolve specific cross-border issues, with the support of IOSCO's secretariat.

If you have any questions regarding our comments, please feel free to contact Adam Jacobs (ajacobs@aima.org).

Yours sincerely,

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Annex 1: Detailed comments

1. Introduction: the cross-border challenge for firms

Many of AIMA's members are active globally, trading in and raising investment from a wide range of jurisdictions across the globe. Consequently, divergence – and, in cases, overlap and inconsistency - between the rules in place in different jurisdictions is a day-to-day reality for our members.

In practice, the approach that a firm takes to dealing with the differences between national rules applicable to cross-border business will ultimately reflect the nature of those differences. In some instances, overlapping rules will be sufficiently harmonised that a single approach enables full compliance with requirements imposed by different authorities. Close international cooperation in the development of legislation makes it more likely that this outcome will be achieved. For example, we would hope that the close international cooperation at BCBS/IOSCO level on the development of a margin framework for non-cleared derivatives transactions will ultimately lead to very consistent national implementation of the framework.

1.1 Race to the top

In some instances, though, it will be possible to comply with competing rules by adopting the highest standard, although this might prompt the question of whether the more onerous of the applicable requirements are proportionate. Without seeking to give an exhaustive account of the situations in which this might be relevant, the following represent the broad areas of regulation for which this is the most relevant consideration for our members:

- Capital requirements
- Remuneration requirements
- Best execution
- Dealing commissions/soft dollars
- Personal account dealing
- Investor disclosures

1.2 Duplication of effort

Alternatively, where rules require a discreet action – such as a transaction report – it might be possible to satisfy competing regulatory requirements by taking additional compliance steps. This does, however, create additional cost, which will not necessarily be justified. Examples include:

- Reporting of an OTC derivatives transaction to multiple trade repositories
- Registration of investment managers/investment advisers/commodity trading advisers/commodity pool operators with multiple authorities
- Reporting of similar, but not identical information, to the SEC/CFTC under Form PF/Form CPO-PQR and to European authorities under Article 24 of the AIFMD
- Use of IFRS rather than being mandated to use US GAAP for annual reports

1.3 Ceasing activities and/or restructuring

Ultimately, however, it is also possible for overlapping rules to create situations where full compliance with all applicable requirements is impossible. The outcome might be that the entity in question

decides not to enter into the transaction, rather than risk supervisory action due to a rule breach. The following are examples of such situations:

- Clearing of an OTC derivatives transaction under different clearing models
- Personal account dealing (in some countries where data protection rules prevent compliance)
- Exemptions from certain regulatory requirements permitted for registered commodity pool operators ('CPOs')of certain publicly offered US investment companies vs. lack of exemptions for registered CPOs of listed foreign funds although the rationale for having the exemption applies equally

As a result, there are many examples of restructuring on the part of regulated firms seeking to avoid the cost and complication that arises from overlapping standards. For example, in the context of OTC derivatives reforms, there is ample evidence[2] that liquidity in the market place has bifurcated into US and EU liquidity pools, as participants in the market reassess their trading relationships in order to minimize the risk of becoming subject to competing US and EU regulatory requirements.

A similar situation is apparent when it comes to the structuring decisions of asset management firms, with an increasing tendency for them to adopt a 'silo' approach that avoids combinations of manager/fund domicile/investor location that could lead to competing regulatory requirements arising for the asset management structure as a whole. Even when a firm attempts to structure its activities to avoid being subject to multiple regulatory frameworks, it may be difficult if not impossible to make sure that this has been accomplished.

2. Dealing with cross-border issues: existing approaches

2.1 Substituted compliance

We appreciate that regulators recognize the difficulties that are created where their respective rules diverge, overlap or conflict, and many have sought to develop 'substituted compliance' structures, whereby an entity can satisfy its obligations by following the rules of another jurisdiction – essentially because the rules are similar enough that regulators will have comfort that their supervisory objectives will still be met. While this is clearly less desirable than an approach that avoids overlap of rules in the first place (which is discussed in further detail below), it nevertheless offers advantages in terms of providing relief from conflict of law and is important as a means to tackle situations where a transaction between entities from different jurisdictions would otherwise be subject to rules imposed on each of the counterparties to the transaction. There are a number of ways in which the extent of substituted compliance availability will be defined, some of which are more effective than others:

- **Equivalence of outcomes:** There will typically need to be an assessment of the "equivalence" or "comparability" of another jurisdiction's rules before substituted compliance is permitted. The basis on which this assessment is made is extremely important. Given differences between the legal frameworks of different authorities, subtle differences between rules on similar topics are to be expected – even if the rules are motivated by the same international agreement. Therefore, an approach based on broad equivalence of outcomes is more likely to be successful when it comes to dealing with situations of overlap/conflict. In the context of reforms that stem from a G20 commitment, it might be appropriate to assume that rules of counterpart jurisdictions are equivalent, unless a finding to the contrary has been made.

[2] See ISDA study: Cross-Border Fragmentation of Global OTC Derivatives: An Empirical Analysis, January 2014 (http://www2.isda.org/attachment/NjIzNw==/Cross%20Border%20Fragmentation%20-%20An%20Empirical%20Analysis.pdf)

- **Reference to internationally agreed standards:** Where national and regional rulemaking is driven by an international standard or agreement, then it is appropriate to make the international standard the basis for substituted compliance. This is the approach taken by the European Commission in its Proposed Regulation on Benchmarks.[3]

- **Reciprocal relief:** Regulators have a natural interest in ensuring that relief is reciprocal – that authorities to whose rules they defer also show such deference. However, reciprocity can become problematic when it becomes a formal criterion in an equivalence assessment, and can become an impediment to dealing with overlap. Indeed, difficulties associated with reciprocity can be compounded by the likelihood that different jurisdictions will proceed at a different pace when it comes to adopting regulations.

- **Detailed correspondence of rules:** As noted above, assessing that another jurisdiction's rules achieve equivalent outcomes is a reasonable approach in deciding whether to make substituted compliance possible. However, it is not desirable to conduct an equivalence assessment on the basis of demonstrating full and detailed correspondence of rules – something that is highly unlikely to be achieved.

- **Domicile:** Relief might be available to entities legally established in a jurisdiction whose rules have been deemed equivalent. However, this approach does not recognise the fact that the scope of legal requirements does not necessarily align with country borders: an entity could well be subject to the rules of a territory other than the one in which it is legally established. Accordingly, relief mechanisms work more effectively when they benefit entities subject to the rules of the equivalent jurisdiction, rather than merely entities established there.

2.2 Mutual recognition

Mutual recognition is based on an agreement between authorities (typically on a bilateral basis) that they will recognise their counterpart's rules, allowing specified entities to operate (or products to be sold) cross-border without additional compliance obligations arising. It has benefits over substituted compliance, in as much as it in theory avoids explicit overlap of rules arising in the first place. However, many of the qualifications that apply in respect of substituted compliance – how closely rules confirm; domicile of entities; reciprocity – are equally capable of becoming a bar to full mutual recognition.

2.3 Regulatory discretion

In addition to substituted compliance, there might be additional ways in which regulators can provide relief from their rules for participants who are confronted with overlapping/conflicting requirements, notably where a regulator is provided by legislators with a degree of discretion to determine the scope of its framework, and to provide targeted relief to entities or activities when it is appropriate to do so. Providing discretion in this manner is preferable to a framework that requires legislative change in order to deal with shortcomings in how primary legislation has been scoped.

[3] See Proposal for a Regulation of the European Parliament and of the Council on indices used as benchmarks in financial instruments and financial contracts (http://eur-lex.europa.eu/legal-content/EN/ALL/;jsessionid=gbLPTpvPpTVwhz3XQyB8Tn2H7XxF8LVBwvL0QTQJJlbBGlCkYCpD!-1237459123?uri=CELEX:52013PC0641)

3. Dealing with cross-border issues: a possible role for IOSCO

Given the conditionality associated with substituted compliance and mutual recognition, they rarely provide a complete solution to issues of overlap arising in relation to particular activities or in relation to participants in a particular sector. Accordingly, we see a clear role for IOSCO to develop an internationally agreed approach to cross-border issues, built around the following:

i. **Development of an overarching set of Principles for Defining a Sound Regulatory Perimeter:** Focusing on those markets that are already global in nature and characterised by a significant volume of cross-border activity – such as OTC derivatives or asset management – IOSCO should seek to develop sector-specific indicators of the activities that should be subject to local regulation.

ii. **Tackling cross-border issues in all sectoral principles:** An approach to IOSCO sectoral principles whereby all new principles would address issues of cross-border application of rules, to the extent relevant. A good example of this development was IOSCO's work on margin for non-cleared derivatives.

iii. **Development of clear regulatory hierarchies:** Where an entity conducts the same activity in more than one jurisdiction, then the potential for overlap is likely to arise. Accordingly, IOSCO could look to develop a formal framework – or hierarchy – to determine which regulator should have jurisdiction in a given situation. For example, where a transactional requirement arises in respect of a transaction between two entities (say central clearing of an OTC derivatives contract), then the hierarchy could stipulate which set of rules would apply to the transaction, e.g. the rules of the jurisdiction of the dealer counterparty to the trade. Essentially, there should be a lead regulator established and any other regulator that has an appropriate interest in the transaction could be granted access to relevant information about the transaction.

iv. **Development of additional information exchange mechanisms:** IOSCO should seek to build on the Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information with a view to supporting the agreements made between regulators according to the hierarchy described above.

v. **Creation of a cross-border advisory forum:** In order to ensure the effective application of this framework, we support the longer-term ambition of IOSCO developing a more formal dispute resolution mechanism, in order to provide a forum for IOSCO members to discuss specific issues arising from particular cross-border roles. However, a more realistic first step could be the creation of an advisory forum, supported by the IOSCO secretariat, in which competent authorities could discuss the appropriate application of the IOSCO Principles for Defining a Sound Regulatory Perimeter, as well as the application of the associated regulatory hierarchy and potentially seek non-binding mediation on issues brought to the forum by the relevant competent authorities.

3.1 Development of an overarching set of IOSCO Principles for Defining a Sound Regulatory Perimeter

The most effective way to deal with cross-border issues is to design a regulatory framework that minimizes the scope for overlap between the rules of different jurisdictions in the first place. Many of the issues that our members have encountered in respect of cross-border business arise from a regulatory approach on the part of one or more regulators that is overly expansive and that seeks to regulate activities that do not necessarily have a direct bearing on the jurisdiction in question.

At a high level, we believe that the following high-level considerations could form the basis for more detailed IOSCO Principles for Defining a Sound Regulatory Perimeter:

i. **Regulating activities that occur within the regulator's territory:** In scoping their rules, regulators should first consider the specific activities and services which should be regulated in their jurisdiction – rather than seeking to regulate any entity that operates in the jurisdiction in question. In practice, this would entail defining a clear regulatory objective (whether investor protection or systemic risk mitigation, for example) and considering what commensurate degree of oversight of participants would be appropriate, also taking into account rules and regulations elsewhere globally. If there is a need for additional local regulation, the authority or legislator would put in place rules governing specific activities occurring within its jurisdiction.

ii. **Jurisdiction should not be defined with reference to a particular product:** Seeking to regulate an entity on the basis of the products or market that it trades is likely to be incompatible with the principle of regulating on the basis of which territory an activity occurs in – exposure to a particular product does not necessarily entail provision of a service or activity in the local jurisdiction. Accordingly, an important feature of an effective approach to scoping of rules is to avoid defining jurisdiction in this manner.

iii. **Jurisdiction should not be defined with reference to the location of status of investors:** Like firms, investors will frequently seek exposure to entities that operate outside of their home jurisdiction, and this should not necessarily become a test for defining scope of regulation – the more relevant consideration is whether the nature of investors' relationship with the third-country entity is such that it can be considered to be providing a service locally that should be subject to regulation, as described above.

iv. **Authorities should pay due regard to the commercial benefits of cross-border business:** While the remit and responsibilities of IOSCO members means that they will inevitably be focused on how to address the risks arising from cross-border business, it is important to bear in mind the benefits – for individual markets, economies and for competition – that arise when firms are able to operate in multiple jurisdictions without being impeded by unnecessary regulatory conflicts.

3.2 Development of clear regulatory hierarchies

As noted above, an-activity based approach to scoping rules would significantly reduce the risk of overlap of requirements, although it would not eliminate it entirely, particularly where an entity conducts the same activity in more than one jurisdiction or where a transactional obligation arises in respect of a transaction between two entities in separate jurisdictions.

Accordingly, we believe that IOSCO should seek to draw on the precedents already set in the development of national regulation – for example, the hierarchy associated with the determination of the reporting party under the CFTC's swap framework.[4] The goal would be to develop a framework that would be sufficiently granular and transparent that regulators would be able to apply it in a straightforward manner, leading to predictable outcomes for participants in the sector or market concerned.

[4] Commission final rulemaking on "Swap Data Recordkeeping and Reporting Requirements", 77 Fed, Reg. 2207 (January 13, 2012), available at: http://www.gpo.gov/fdsys/pkg/FR-2012-01-13/pdf/2011-33199.pdf . *See* also Commission final rulemaking on "Swap Data Recordkeeping and Reporting Requirements: Pre- Enactment and Transition Swaps", 77 Fed. Reg. 35200 (June 12, 2012), available at: http://www.gpo.gov/fdsys/pkg/FR-2012-06-12/pdf/2012-12531.pdf.

In effect, this would be an extension of the principle of mutual recognition, and create a multilateral approach to recognition of the rules that individual IOSCO members have put in place. It would not be necessary for all IOSCO members to adopt the hierarchy for a given area of rules, unless appropriate from the point of view of the nature of their local market and the entities operating there. Typically broader IOSCO standards would be developed and implemented ahead of a formal hierarchy, ensuring that the regulatory baseline would be comparable across those jurisdictions adhering to the standards.

3.3 Development of additional information exchange mechanisms

We appreciate that regulators might have reservations about deferring to rules of another jurisdiction as a consequence of application of the hierarchy, given that it might reduce their ability to obtain information relevant to their broader supervisory objectives. However, we believe that this objection can be readily overcome by further developing the *Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information*, developing specific information exchange templates for different sectoral principles.

3.4 Creation of a cross-border advisory forum

In order to ensure the effective application of this framework, we support the longer-term ambition of IOSCO developing a more formal dispute resolution mechanism, in order to provide a forum for IOSCO members to discuss specific issues arising from particular cross-border roles. However, a more realistic first step should be the creation of an advisory forum, supported by the IOSCO secretariat, in which authorities could discuss the appropriate application of the IOSCO Principles for Defining a Sound Regulatory Perimeter, as well as the application of the associated regulatory hierarchy. IOSCO could provide non-binding guidance, helping to address any possible shortcomings in the application of the Principles in a given context, ideally before the relevant local rules come into force – in effect serving as an early-warning system.

3.5 Illustration: OTC Derivatives Reforms

Applying the framework above to the case of OTC derivatives reform illustrates how it could work in practice:

IOSCO Work	**Actions**
Development of principles for an effective regulatory perimeter	• Definition of objectives: primarily systemic risk mitigation • For asset managers: Entity-level requirements apply according to principal jurisdiction in which an entity performs portfolio management • Investor domicile would not determine jurisdiction
Development of regulatory hierarchies	• Relevant transactional obligation would be that of the dealer counterparty where transaction involves client from a different jurisdiction • Potential for choice of jurisdiction where rules/outcomes are comparable
Information exchange mechanism	• Harmonise trade repository reporting fields and develop templates for mutual access to data
Dispute resolution forum	• Specific consideration of different types of participants: market infrastructure; dealers; buy-side clients; end users

Annex 2: OTC Derivatives Reform: Dealing with overlap of rules [slide deck]