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The scale of misconduct in some financial institutions has risen to a level that has the potential to create systemic risks. Fundamentally, it threatens to undermine trust in financial institutions and markets, thereby limiting some of the hard-won benefits of the initial reforms. Financial Stability Board Chairman Mark Carney, in a February 4, 2015 letter to G20 Finance Ministers and Central Governors.

Comment on IOSCO Task Force Report on Cross-Border Regulation: Consultation Report (CR09/2014)ⁱ

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Dear Mr. Tendulkar,

The Institute for Agriculture and Trade Policyⁱⁱ is pleased to have the opportunity to comment on the above-captioned Consultation Report (CR). IATP thanks IOSCO for giving the international financial regulatory community a succinct summary of cross-border regulatory instruments and challenges to implementation of those instruments and related regulatory practices. IATP is also grateful that IOSCO published minutes of its three meetings with industry representatives, academics and other key stakeholders. These minutes were very useful in informing the following comment.

This comment comprises introductory remarks that situate the CR in the context of G-20 finance ministers' and central bankers' commitments regarding systemic risk, and comments on three types of existing cross-border regulatory practices identified in the IOSCO Task Force survey of IOSCO member regulators. Much of the financial misconduct alluded to above by Chairman Carney is the result of the opportunistic exploitation of gaps in cross-border regulation and/or lack of effective cooperation among regulators in different jurisdictions. Therefore, it is urgent that IOSCO's Task Force specify and promote cross-border regulatory practices that will enforce IOSCO jurisdictions' laws across borders.

IOSCO's Mandate and the G-20 Financial Regulatory Reform Process

The G-20 Leaders and the G-20 Finance Ministers and Central Bank Governors have recognized that the effective implementation of regulations applied to cross-border trading on exchanges and

Over the Counter (OTC) is crucial to realize the G-20's commitment to broad and deep financial services reform. The Finance Ministers and Central Bank Governors wrote, "jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulatory and enforcement regimes, based on similar outcomes, in a nondiscriminatory way, paying due respect to home country regulatory regimes."ⁱⁱⁱ The IOSCO Task Force on Cross-Border Regulation's "Consultation Report" (CR) aims to provide a "toolkit" of three types of regulatory practices or "tools" to enable regulators to determine whether and to what extent such jurisdictional deference is warranted. We will comment below on these types of regulatory practice -- national treatment, recognition and passporting -- relative to the objective of verifying regulatory outcomes, such that jurisdictional deference would be justified.

Past IOSCO work has sought to assist regulators in "securing compliance with and enforcing securities and derivatives laws and regulations" (CR, 3). However, according to the CR, this "Task Force will not duplicate the work of other international work streams, in particular the ongoing work relating to the over-the-counter (OTC) derivatives reform agenda" (CR,2). We are surprised and concerned that the CR intends to focus only on "key challenges and experiences faced by regulators in implementing cross-border securities regulations" (CR, 2). Task Force meetings with industry representatives and other stakeholders discussed OTC derivatives and particularly the problems of getting industry to supply regulators with high quality, timely and comprehensive trading data, a pre-requisite for computer enabled data surveillance and effective cross-border regulation.^{iv}

For example, one view at the Washington, DC meeting was that "IOSCO should take a stronger lead at the outset in terms of rulemaking or reconciling differences in the derivatives reform space. IOSCO may need 'more teeth' in the international regulatory community."^v At the industry representatives and stakeholders' meeting in London, at no point in the discussion of "The role of IOSCO in cross-border issues," is there any suggestion that that role be limited to the cross-border regulation of securities trading.^{vi} The apparent self-delimitation by the Task Force to cross-border regulation applied to securities only may result in failure to achieve one of IOSCO's three core regulatory goals, namely the "reduction of systemic risk" (CR, 3).

Systemically Important Financial Institutions (SIFIs) and other large financial institutions trade both securities and OTC derivatives. At the entity level, these trading risks are shared among the parent entity, its branches and affiliates. Commonality of asset holdings among SIFIs and other large financial institutions is a risk multiplier for the entire financial system^{vii}, even with effective cross-border regulation to prevent regulatory arbitrage and evasion.

We believe that the Task Force should view its work as overlapping with that of the OTC Derivatives Regulators Group (ODRG), which "is also discussing how deference to foreign regimes will work in practice in the context of equivalence assessments and substituted compliance determinations."^{viii} As far as we know, the ODRG does not have a consultation process comparable to that of IOSCO or the Financial Stability Board. We hope that IOSCO will open soon a consultation process on cross-border regulation focused on OTC derivatives, as indicated by FSB Chairman Mark Carney in a February 4 letter to G-20 Finance Ministers and Central Bank Governors: "IOSCO will finalise the measures in its proposed cross-border regulatory toolkit. These will be applicable not only for OTC derivatives but also for other market regulation."^{ix}

We were surprised to learn that although IOSCO has engaged in various aspects of cross-border regulation over the past decade, “IOSCO has not previously studied or developed an overall understanding of various approaches to cross-border regulation” (CR, 3). Applying cross-border regulation only to the securities trading of SIFIs and other large financial institutions may create an international regulatory gap if the ODGR does not work with IOSCO to ensure that cross border regulation applies to all current and future asset classes and trading instruments. As the Task Force chair of the Washington, DC meeting noted, “At a practical level, when there is a crisis, regulators will quickly get together to resolve issues (e.g. the ODRG which is outside IOSCO but comprised of IOSCO members).”^x The ODRG and IOSCO should not wait until there is a crisis to work together to agree on cross-border regulatory tools that respond changing markets, trading technologies and regulatory arbitrage and evasion strategies.

The lack of effective cross border regulation was certainly a major factor contributing to trillions of dollars of economic damage (\$7.3 trillion is the lowest credible estimate just for the United States alone) resulting from the global financial services industry crisis of 2007-2009.^{xi} That crisis triggered nearly \$30 trillion in emergency, ultra-low interest rate loans to SIFIs and central banks from the U.S. Federal Reserve Bank in 2007-2010,^{xii} to prevent myriad default cascades from SIFIs through the financial system. Given this all too recent history of regulatory and market failure, the Task Force should view some regulatory redundancy as a necessary safeguard against competitive pressures that may lead to regulatory arbitrage and evasion, rather than as an unnecessary burden on the industry.

IOSCO’s report on cross-border regulation for the 2015 G-20 Finance Ministers and Central Governors’ meeting should more clearly define its mandate to explain how its application of cross-border regulation to securities only will reduce systemic risk among SIFIs and other large financial institutions. Alternatively, the Task Force should expand its report to cover the cross-border regulation of OTC derivatives, requesting a time extension, as appropriate, to do so.

The CR’s Methodology and Cross-Border Regulatory Challenges

The CR is in part the result of a survey in 37 IOSCO members and Task Force meetings in Hong Kong, London and Washington, D.C. “with industry representatives, academics and other key stakeholders to seek their views on what they believe to be the most important issues and challenges in complying with cross-border regulation, and to elicit their suggestions on how regulators could enhance cross-border coordination” (CR, 6). Given IOSCO’s history as a standard setting body, it is understandable that much of the Task Force characterization of cross-border regulatory tools is in terms of standards and the regulatory process for the recognition of the standards of one jurisdiction as equivalent to those of another.

Nevertheless, we believe that IOSCO’s report to the G-20 Finance Ministers and Central Bank Governors must emphasize that the three types of regulatory practice characterized in the CR require data justified verification in order to be effective cross-border regulatory “tools.” The CR reports that “regulatory “outcomes” in the cross-border recognition practice are “generally pre-determined and comparable to those achieved by the domestic regulator” (CR, 18). It is crucial that the final IOSCO cross-border regulatory report distinguish between the categories of pre-determined regulatory outcome measures reported by IOSCO member regulators (CR, 49-50) and the achievement of regulatory outcomes in practice. The final IOSCO report should highlight those outcomes that can only be verified by unfettered and timely cross-border access to trade data, reported to IOSCO with common data elements, as proposed in the FSB data aggregation

proposal. IOSCO member regulators reports to the Task Force that “insufficient access to overseas data and documents” (CR, 41) is one of their major regulatory challenges to overcome to fulfill the G-20 financial reform commitments. IATP does not share the view of the International Swaps and Derivatives Association that IOSCO’s template for regulator access to cross-border trade data is “disproportional” to the G-20 commitments.^{xiii} There are technical means proposed, such as the Legal Entity Identifier, to make trade data semi-anonymous, which would both protect the identity of individual traders and trades while enabling regulators to aggregate trade data across borders for surveillance purposes, both to determine compliance with domestic rules and to prevent systemic risks. What is lacking is agreement by SIFIs and other large financial institutions to submit data in common templates to enable cross-border surveillance, and legislative changes in IOSCO jurisdictions to enable regulator access to data.

National Treatment

In the context of the “national treatment” cross-border tool, the CR cites IOSCO’s Multilateral Memorandum of Understanding and the U.S. Commodity Futures Trading Commissions Memorandum of Understanding for derivatives trading as examples of cross-border regulatory cooperation for supervisory and enforcement activities. (CR, 13) However, Task Force regulators surveyed report restrictions “that may limit or prohibit their direct access to the books and records of, and direct communication with, entities located abroad that are of regulatory interest to them” (CR, 14). This is a grave cross-border regulatory limitation, particularly as it pertains to a fundamental problem of cross-border regulation, i.e. the willingness of industry to provide timely and high quality trading data for regulatory surveillance. As the Senior Supervisors’ Group recently in 2014 to the Financial Stability Board, “Five years after the financial crisis, firms’ progress toward consistent, timely, and accurate reporting of top counterparty exposures fails to meet both supervisory expectations and industry self-identified best practices. The area of greatest concern remains firms’ inability to consistently produce high-quality data.”^{xiv}

Under the “Regulatory Objectives of National Treatment,” competent authorities must demand that the consistent provision of high-quality data is a core feature of national treatment. In other words, to the Task Force requirement that “all foreign entities seeking to conduct business within a host market are aware from the outset of the specific requirements necessary to register and operate within the applicable jurisdiction” (CR, 10), we would add, “including near real time provision of trade data, with standardized data elements, to enable their computer enabled surveillance.”

The minutes of the Washington, DC meeting state, “The TR [Trade Reporting] process in the EU and US are currently not structured to provide regulators with the information they need and at the time it is needed. It was mentioned that the industry would have to incur significant costs to enable regulators to obtain the information they need during a time of crisis. A more efficient process would be if clearing houses were able to share the information they hold directly with regulators and TRs would only hold information on trades that are not cleared.”^{xv} Non-industry studies show that the cost-to-industry argument is over-estimated.^{xvi} Certainly, regulators should not wait until a crisis to demand comprehensive and standardized trade data. Finally, we are relieved that the CR does not incorporate the industry proposal that each clearing house report trades to regulators and that Trade Data Repositories record information only about trades not accepted for clearing. Such a proposal might be more “efficient” for reporting entities, but it would surely be inefficient for regulators who are already under-resourced relative to size, complexity and inter-connectedness of the markets they oversee.

However, even if the costs to industry of supplying trade data are “significant,” the provision of timely and comprehensive trade reporting data according to internationally agreed data elements, as proposed by the Financial Stability Board, is part of the requirements to secure the benefits of a well-regulated financial system. A Bank for International Settlements study estimates the macro-economic benefits to cost ratio of an international financial system regulated according to realized G-20 reforms at 4:1.^{xviii} IOSCO, like other international financial regulatory bodies, must place the integrity and viability of the global financial system above the claimed costs and interests of SIFIs and other cross border trading financial institutions.

Recognition

The assessment of foreign regulatory regimes, for the purpose of determining whether unilateral or mutual recognition of regimes or regulatory measures is justified, should be based on publicly available criteria. The CR reports that “Depending on the regulator, the [assessment] guidelines may or may not be publicly available” (CR, 19). In order for interested parties to comment on provisional recognition determinations, the Task Force should agree that IOSCO members publish such guidelines.

Because the timeframe for a recognition determination depends in part on the timely and complete provision of requested documentation and data by the foreign regulator, IATP does not believe that IOSCO should recommend a timeframe for the completion of recognition determinations. Furthermore, domestic regulator budgetary and personnel reductions or constraints may result in a longer recognition determination process.

However, it is reasonable for the foreign regulatory and foreign entities affected by the recognition determination to receive prompt responses to questions they pose about the assessment guidelines and process. Furthermore, upon initial evaluation of a complete documentation packet for the recognition request, IATP believes that IOSCO should recommend that its members provide an interim assessment to the foreign regulator, indicating topics about which further documentation and/or on-site reviews might be required.

Major changes to domestic legislation or regulation of the securities and derivatives markets and entities should result in a re-assessment of the recognition determination. Save for emergency regulatory responses, foreign regulators and entities affected by the re-assessment should be notified of reassessment upon the publishing of a final rule that affects the recognition determination. The guidelines for re-assessment should be published as part of the overall assessment guidelines.

We agree with those IOSCO regulators who find it inappropriate to undertake a recognition determination assessment, when the foreign regulators rules have not been finalized or implemented (CR, 22). A mid-assessment regulatory change or non-implementation of a rule, e.g. due to an industry lawsuit to annul the rule, could result in regulatory resources being wasted on the evaluation of rules, implementation or enforcement practices that might no longer be valid. As the Task Force survey respondent notes, recognition assessments are resource intensive to negotiate and recognition determinations are resource intensive to monitor for compliance (CR, 24-25).

Passporting

Passporting of cross-border regulation is viable when different jurisdictions are regulated by a common set of regulations and underlying legislative authorities, such as among European Union member states or Canadian provinces. Passporting requires the high degree of legal homology that confederation affords, so it is not a model of cross-border regulation that can be undertaken by IOSCO jurisdictions that lack such confederation. As the Task Force notes, the central governing body necessary to implement and supervise passporting would be difficult to create at the international level (CR, 39).

The EU examples of passporting concern securities and mutual funds. The survey respondents indicate that passporting has been successful in achieving all regulatory objectives and in raising capital for firms in EU member states (CR, 33). In addition to the passporting “down sides” identified by the Task Force, we would add that the regulatory efficacy of passporting is only as strong as its weakest regulatory jurisdiction(s). Particularly, for jurisdictions attempting to implement passported rules applied to financial innovations, either granting regulatory exemptions or compliance waivers or the hasty approval of complex new products could transmit an ill-considered regulation or a regulatory evasion through the passported system.

The potential for regulatory evasion is by no means limited to passporting via the weakest jurisdiction. Rules can be written that facilitate evasion. For example, as *The New York Times* wrote of the U.S. Securities and Exchange Commission’s 2014 rule on the cross-border regulation of securities-based swaps, “Under the S.E.C. rule, derivatives regulations will apply to foreign affiliates of American banks only if the affiliates’ derivatives contracts are explicitly guaranteed by the American parent banks, say, by writing a guarantee into a contract . . . By imposing new rules on guaranteed affiliates only, the S.E.C. has invited the banks to avoid the rules simply by doing away with explicit guarantees.”^{xviii} In a comment deploring the S.E.C. engineered loophole, Americans for Financial Reform noted that more than 90 percent of securities-based swaps transacted on U.S. markets in 2011 “involve a nominally foreign counterparty.”^{xix} What is particularly disheartening about the S.E.C. rule to invite “deguaranteeing” of securities-based swaps contracts is that the S.E.C. knew of the extent of bank “deguaranteeing” that resulted from an earlier loophole from the U.S. Commodities Futures Trading Commission.

If IOSCO is to help stem the tide of regulatory evasion of G-20 commitments to regulate the OTC derivatives markets and prevent build-up of systemic risk in the derivatives markets, the Task Force should produce a study of regulatory evasion for the G-20 finance ministers and central bank governors. Advice to IOSCO jurisdictions on the prevention of regulatory evasion should be part of the IOSCO cross-border toolkit.

The next financial industry crisis is unlikely to look like the most recent one.^{xx} Nevertheless, the prevention of cross-border regulatory evasion will surely be an important tool to limit the extent of damage of that next crisis.

Conclusion

The application of domestic rules to cross-border trading and clearing is a complicated task in the best of circumstances. It becomes all the more difficult when government policy about financial service regulation is or even appears to be inconsistent or incoherent. We recommend to IOSCO member regulators that they consult with their governments' negotiators of financial services and regulatory cooperation chapters of proposed trade and investment agreements to ensure that regulatory measures are not contradicted, weakened or precluded in those agreements. IATP has made this recommendation to the Financial Stability Board secretariat, as a result of our brief evaluation of a leaked draft of the financial services chapter of the Trade In Services Agreement.^{xxi}

We look forward to cooperating with IOSCO through comments on its future consultation papers to improve cross-border regulation.

Respectfully submitted,

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ⁱ <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD466.pdf>

ⁱⁱ IATP is a U.S. nonprofit, 501(c)(3) nongovernmental organization, headquartered in Minneapolis, Minn., with an office in Washington, D.C. Our mission states, "The Institute for Agriculture and Trade Policy works locally and globally at the intersection of policy and practice to ensure fair and sustainable food, farm and trade systems." To carry out this mission, as regards commodity market regulation, IATP has participated in the Commodity Markets Oversight Coalition (CMOC) since 2009, and the Derivatives Task Force of Americans for Financial Reform since 2010. IATP has submitted several comments on U.S. Commodity Futures Trading Commission rulemaking, and on consultation papers of the International Organization of Securities Commissions, Financial Stability Board, the European Securities and Markets Authority, and the European Commission's Directorate General for Internal Markets.

ⁱⁱⁱ Communiqué Meeting of Finance Ministers and Central Bank Governors Sydney, 22- 23 February 2014, available at https://www.g20.org/sites/default/files/g20_resources/library/Communique%20Meeting%20of%20G20%20Finance%20Ministers%20and%20Central%20Bank%20Governors%20Sydney%2022-23%20February%202014_0.pdf

^{iv} E.g. IOSCO Task Force minutes of its meeting on April 28, 2014 in Washington, D.C. at 2-4. [http://www.iosco.org/library/cross-border-taskforce/pdf/Washington-DC-industry-meeting-summary-\(28-April-2014\).pdf](http://www.iosco.org/library/cross-border-taskforce/pdf/Washington-DC-industry-meeting-summary-(28-April-2014).pdf)

^v Ibid, at 5.

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- ^{vi} IOSCO Task Force minutes of its meeting on April 25, 2014 in London, at 10-12.
[http://www.iosco.org/library/cross-border-taskforce/pdf/Summary-of-London-Industry-Meeting-\(25-April-2014\).pdf](http://www.iosco.org/library/cross-border-taskforce/pdf/Summary-of-London-Industry-Meeting-(25-April-2014).pdf)
- ^{vii} Sharon Blei and Bakhodir Ergashev, “Asset Commonality and Systemic Risks Among Large Banks in the United States,” Economics Working Paper 2014-3, Office of the Comptroller of the Currency, September 2014. <http://www.occ.gov/publications/publications-by-type/occ-working-papers/2013-2009/wp2014-3.pdf>
- ^{viii} “Report of the OTC Derivatives Regulators Group (ODRG) to G-20 Leaders on Cross-Border Implementation,” November 2014 at 3.
http://www.esma.europa.eu/system/files/odrg_report_7_november_2014.pdf
- ^{ix} Mark Carney, “Financial Reforms—Finishing the Post-Crisis Agenda and Moving Forward,” Financial Stability Board, February 4, 2015, at 5. <http://www.financialstabilityboard.org/wp-content/uploads/FSB-Chair-letter-to-G20-February-2015.pdf>
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- ^{xi} Tyler Atkinson, David Luttrell and Harvey Rosenblum, “How Bad Was It?: The Costs and Consequences of the 2007-2009 Financial Crisis,” Federal Reserve Bank of Dallas, July 2013.
<http://dallasfed.org/assets/documents/research/staff/staff1301.pdf>
- ^{xii} James Andrew Felkerson, “\$29,000,000,000,000: A Detailed Look at the Fed’s Bailout by Funding Facility and Recipient,” Levy Economics Institute, Working Paper 698, December 2011.
http://www.levyinstitute.org/pubs/wp_698.pdf
- ^{xiii} “Consultative report on Authorities access to trade repository data,” International Swaps and Derivatives Association comment to IOSCO, May 10, 2013, at 4-5.
<http://www.iosco.org/library/pubdocs/408/pdf/ISDA.pdf>
- ^{xiv} “Progress Report on Counterparty Data,” Senior Supervisors Group, January 15, 2014,
https://www.financialstabilityboard.org/publications/r_140116.pdf
- ^{xv} IOSCO Task Force minutes at 3.
- ^{xvi} E.g. Dennis Kelleher, Stephen Hall and Katelynn Bradley, “Setting the Record Straight on Cost-Benefit Analysis and Financial Reform at the SEC,” Better Markets, July 30, 2012.
<http://www.bettermarkets.com/sites/default/files/Setting%20The%20Record%20Straight.pdf>
- ^{xvii} “Macro-economic costs and benefits of OTC derivatives regulatory reform,” Bank for International Settlements, August 2013, 2. <http://www.bis.org/publ/othp20.pdf>
- ^{xviii} “Another Failure to Regulate Derivatives,” *The New York Times*, July 2, 2014.
- ^{xix} “Cross-border Securities-based Swap Activities,” Americans for Financial Reform, August 22, 2013, at 3. http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2013/08/AFR_Comment_SEC_Cross_Border_Rule.pdf
- ^{xx} Saytajit Das, “Do eerie parallels presage a crisis?” *Financial Times*, February 23, 2015.

^{xxi} <http://www.iatp.org/blog/201406/reforming-for-international-financial-stability-vs-the-tisa-counter-reformation>