IOSCO Task Force on Cross Border Regulation

Hong Kong Industry Meeting held on 7 April 2014 at the offices of SFC

Summary of discussion

Introduction
The Chair (Ashley Alder) welcomed and thanked all participants for attending the meeting.

The Chair summarized the conclusion of the IOSCO members survey - input from regulators identified cross border challenges such as a lack of common ground and common objectives among regulators, timing issues, a lack of understanding and trust in the regulatory frameworks of other jurisdictions and possibly implementation issues.

Summary of key topics discussed:

1. **Most successful / least successful examples of cross border approaches from industry perspective**

   Successful examples

   Participants shared the following views on successful examples of cross border regulatory initiatives:

   i. The Hong Kong **passport recognition regime for funds**.

   ii. **IOSCO ENF MMOU**

   iii. **IOSCO's work on benchmarks** is an example of a successful cross border initiative which had positive results on national rules.

   iv. The **rules on short selling and position reporting** is a good example of cross border implementation as it was simple and consistent which is helpful for a global end user.

   v. At a practical level, the industry **is not waiting for IOSCO to come out with harmonized standards to address cross border issues**. Firms are implementing either EU or US rules. **It is a race to the top in that firms only comply with EU or US rules**, depending on where the firm is based or is doing business. This increases cost as it does not take into account the differences in requirements between jurisdictions. Global firms have **no choice because they have to comply and avoid reputational risk**. In that sense, EU and US extraterritorial regulation (substituting their rules for national rules) is the **most successful cross border approach** so far.

   Least successful examples

   i. Trade Reporting (TR)

   One of the least successful cross border approaches is in the area of TR. **Many jurisdictions have created their own repositories without any thought as to the interoperability of trade repositories with one**

another. More work should be done in this area including developing common identifiers to help identify where the risk is located.

A concern was raised regarding **derivatives and TR regulation being too broad and high level, lacking sufficient detail** and there being too wide differences in key jurisdictions which cause difficulties for firms to implement.

It was mentioned that it is very difficult for a global bank to deal with more than 3 different interpretations of TR rules by national regulators in Asia. TR rules are difficult to implement due to a **lack of consistent rules** and more detail is required and possibly a centralized way to report the data.

The CPSS-IOSCO report on data reporting requirements for OTC derivatives was too high level, insufficiently granular for industry implementation and was consequently less successful. It was suggested that benchmarking against the PFMI would be helpful.

There was a view that central banks do not understand the need for reporting transactions to 3rd party regulators. Trade reporting is one area where some regulators did not fully understand the need for it and hence, in some jurisdictions, the regulator and even some institutions are not allowing transaction reporting to happen easily.

There was a concern regarding **a lack of trust among regulators** on trade reporting requirements especially during crisis periods.

It was suggested that requiring CCPs to access trades that they clear would be a cheaper and more efficient way to carry out trade reporting. Reporting for uncleared trades would still need to be addressed but the scope would be more contained. It was noted that regulators in both EU and the US had **problems obtaining accurate information from the TR process**. This is because the trade reporting does not reflect how trades are actually reported for the purposes of clearing in a clearing house. This leads to reconciliation problems and **high costs** to ensure proper reconciliation. This can be avoided.

ii. Volcker Rule

Another example of a bad cross border approach was the Volcker Rule which was meant to be outcomes based regarding the exemption of mutual funds. But because each foreign jurisdiction has different rules for registration of funds, **mutual funds around the world ended up being not exempt from the Rule**, as they would fail to comply with the 1940 Act, they would not be registered as a fund in the US. This highlights the importance of having a proper consultation and discussion with industry and regulators at an international level before introducing a rule which has cross border implications.

2. Challenges in specific business lines

Participants provided the following views on this topic:

In terms of derivatives reform:

i. There are **so many reforms happening all at once that the cumulative effects and the reforms all interact with each other**. This makes it difficult to explain to the regulator a specific set of issues of concern or the **cumulative impact on firms** e.g. the cost of the move to central clearing and the costs of holding capital. Timing issues also exacerbate the difficulty.

ii. One of the regulatory themes observed is **increased regulatory risk because of the unknowns** flowing from post financial crisis regulatory reform e.g. significant changes in exemptions in licensing requirements in some jurisdictions, changes in key definitions such US persons, US offerings exemption vs. registration exemptions from CFTC, Volker Rule etc. These are challenging areas for smaller businesses from buy-side firms that are based in Asia to keep abreast of, including answering to different regulators (2 in the US and the home regulator in Asia).

iii. One participant shared their firm's experience and **difficulties in dealing with regimes that have conflicting rules**. An example would be **how equivalence is being applied** in an unproductive way by the EU whereby the ESMA rules claim that it has more conservative margin requirements (2 day margin coverage standard) for CCP than the US. However in the US, although there is a 1 day margin coverage standard, there in conjunction with customer cross margining, effectively means that US CCPs hold on average 220% more margin than the EU regime.

   Another example of an unproductive approach by the US would be liquidity standards (CPSS IOSCO principle) whereby US regulators consider that Treasury securities or any government security would not be included as a liquid resource. In conjunction with a 1 day liquidity coverage standard (compared to a 2 day liquidity standard in EU) this is considered a very conservative implementation approach in the US.

   The concern is that although these conservative rules can improve safety up to a point, after that it merely increases costs of the infrastructure providers and at some point, simply increases the cost to intermediaries and end finance.

   Regulators were encouraged to not impose a strict equivalence regime and adopt a more outcomes based approach and use international standards as the benchmark / minimum standards (e.g. CPSS IOSCO).

   In response to the Chair's question as to what drives the differences between EU and US standards, the participant mentioned the following:

   - **Systemic risk concerns** – which have been primarily satisfied in the US, as more margin is being held in the US compared to the EU.
   - **Regulatory arbitrage** – flight to cheaper jurisdiction. One participant suggested that it would look at the overall costs of doing business, not just 1 or 2 day liquidity standard.
   - **Element of politics** – Playing hardball between EU and US and overreaching in some instances in an effort to reach a compromise. In doing that, regulators and politicians put investors at risk of not having EU persons able to trade US products in December 2014.

ii. In the area of swap regulation, timing issues have also raised **concerns of the first mover advantage for regulators**. To avoid this issue, the industry feels that a better coordinated approach across jurisdictions would be an effective step. One participant shared the experience of certain regulators approaching an industry association saying that they follow the approach of neither the US nor the EU.

iii. Post financial crisis, there was a significant amount of **fragmentation regarding disclosure standards** globally and an increased level of detail with regard to TR and mutual funds.

Non-derivatives related:

iv. Regionally there can be **better coordination of trading hours and diverse settlement periods and processes** (e.g. T+1 vs. T+2), particularly with the demutualisation of exchanges.

v. There was a question as to why doesn't the EU fully adopt the IOSCO standards on benchmarks and not debate and add to it further. It was suggested that ESMA did not have enough resources to consult widely enough which is a concern.

vi. There is a need to have a more **coordinated approach towards professional investor definitions, KYC, AML and licensing exemptions standards** which have not been given sufficient international focus. The Chair remarked that these areas are also important and within the scope of the Task Force. Attention has been diverted from these areas post crisis towards derivatives reform.

vii. There are **duplicative approval costs across Asian jurisdictions**, even for low yield investment products (excluding OTC derivatives). Cross border regulations have not focused on wholesale investment products which are relatively safe products that have pension funds as investors. This has led to fewer of these products being offered cross border.

3. Industry's experience of the relationships between home and host regulators:
i. the geographical scope of cross-border regulations – who is covered and by which regulator (e.g. extraterritoriality related to OTC derivatives), and
ii. cross-border sharing of information (e.g. issues such as those related to data access and protection under local rules)

Participants commented on the ways which securities regulators were implementing cross-border regulations.

One suggestion for securities regulators was to **act local but think global in terms of how a piece of local regulation would impact overseas jurisdictions.** Securities regulators were encouraged to focus more on the potential extraterritorial implications and conduct impact assessments upfront.

Mechanisms for temporary relief for the industry, more clarity on the implementation process and outcomes, and sufficient time for proper

consultation before increasing the granularity of principle-based regulations would always be helpful.

Participants agreed that **communication among regulators, the industry, and policy makers** was an important aspect of effectively implementing cross-border regulations.

Speaking on the importance of having effective communication among regulators, participants pointed out that this was a challenge for IOSCO. **Even if there was unanimous agreement among IOSCO members, there was no guarantee that what was agreed upon would be implemented because local legislation had to be changed, and this was often a political process.** The end result was often similar to the watered-down version of the Basel rules which was different from what the prudential regulators had previously agreed.

Participants further expressed views on how **politics intersect with and influence the implementation of cross-border regulations.**

As in the case of initiating OTC derivatives market reforms, some remarked that **the G20 top down approach was not working well** because it was not subject to global consultation. This had resulted in a lack of coordination and delays.

Others commented that **policy makers had to provide regulators with an effective legislation framework so that they had the legal ability to mutually recognize each other's regulations and build trust.** Otherwise regulators could simply apply national rules.

Some also pointed out that the **IOSCO, FSB and BCBS discussions seldom include policy makers** who were relevant in making decisions.

4. **Examples of regulatory arbitrage:**

   i. **What is an unacceptable and acceptable regulatory arbitrage? One might broadly say that an unacceptable regulatory arbitrage increases systemic risks (e.g. the overuse of offshore financial centers) or brings financial institutions to the competition point where the location of an activity is affected (e.g. earlier discussion on the differences in CCP default funds).**

   ii. **There might also be an argument that regulatory arbitrage and the lack of harmonization between developed and developing markets are justifiable due to their different stages of market development in different jurisdictions.**

   Participants pointed out that the current situation had much more to do with **gold-plating, or a regulatory "race to the top"**. Rather than finding opportunities to avoid regulations in a subversive way, financial institutions now had a **low tolerance of regulatory risk** and took a more cautious approach by trying to apply standards globally.

   There was **no real indication of a regulatory "race to the bottom"**, and most participants agreed that the assumption that businesses would flow to another jurisdiction simply because of different requirements was not happening. It was explained that **firms generally would not shift their businesses simply because of a line-by-line regulatory arbitrage**

possibility, since there were still a lot of uncertainties over what the requirements and what the associated costs would be. For example, the decision of firms on whether to clear with a US CCP or other CCPs would not simply be based on different margin requirements.

5. **Cross-border activities that require more prioritization by regulators from the industry's perspective**
   1) **To what extent has the debate on OTC derivatives reforms hijacked the discussion on cross-border regulations?**
   2) **Views on different cross-border regulatory techniques that are being used.**
   3) **Enforcement MMoU and strengthening supervisory cooperation (information sharing, joint inspections, supervision of firms, etc.)**

Participants were **in favor of securities regulators developing mutual recognition regimes** to oversee financial entities (e.g. CCPs, exchanges, subsidiaries and branches of financial institutions, etc.). It was suggested that **international standards should be used as the baseline** to drive mutual recognition regimes. For example, currently the EU appeared to require super-compliance with the CPSS-IOSCO principles in order for CCPs to be deemed equivalent.

Other priorities that were mentioned during the meeting include:

i. The **standardization of the format and process of data collection**

ii. Having a **clear and feasible global roadmap to implement regulatory reforms**

iii. Establishment of a threshold so that **jurisdictions whose activities fell below the set threshold did not need to meet relevant internationally-agreed standards**

iv. Establishment of a mechanism which would **allow developing markets to implement internationally-agreed standards at a later stage** instead of rushing through the reforms without thorough understanding. This aimed to avoid introducing requirements that might not be suitable.

v. In the area of OTC derivatives, should there be too much regulation in US and EU, this could **shift risk to Asia Pacific markets** as some firms may possibly choose to work with counterparts that are not as well regulated. This is something IOSCO should look into. Government and regulators should also discuss the possibility of developing principles around FATCA before implementation as FATCA developments, which are US driven, impact most financial institutions.

vi. Regulators also faced challenges in terms of allowing passporting regimes. For example, **UCITs products have become a lot more complicated with the use of derivatives and expanded investment powers**. As such, regulators are becoming less comfortable in passporting such products into their home market. Perhaps there is a need to ask the EU whether UCITs should be a common brand or tiered to cater for different jurisdictions.

6. Ways to improve cross border regulatory coordination

i. Roles and relationships among the G20, IOSCO, other standard-setters and the industry

ii. **IOSCO's role in facilitating supervisory cooperation (e.g. should IOSCO state what powers national regulators must have at a minimum to engage in supervisory cooperation?)**
iii. **Role of international standards**
iv. **Whether we should locate more decision-making to the international level**
v. **Whether more details should be provided since some think that the principles or standards are not granular enough, and this affects the formulation of national standards**
vi. **Criteria for equivalence assessments and criteria to judge what similar outcomes are expected**

The Chair remarked that national regulators are legally bound to protect their own population and there is substantial resourcing needed to assess whether the home regulation is adequate to protect the host product or fund. In addition, there is the added complication of the need not only to compare rules but also the ability to enforce and supervisory cooperation.

Participants had the following suggestions:

- When jurisdictions came up with new regulations that had cross-border impact, IOSCO could **help increase transparency at the policy-making stage and the implementation stage.** For example, the relevant jurisdiction could communicate the impact assessment of its proposed rules to other markets through IOSCO. This could possibly help regulators **initiate a dialogue earlier and escalate issues to politicians** if needed.

- It was important for global standard setters like IOSCO to **engage with politicians to frame the rules effectively**. During the development of the OTC reforms, it was unfortunate that Asian regulators were silent throughout the debate and as a result, the reforms were pushed through. **FSB should have framed the process at an early stage to pre-empt the legislative outcomes post crisis**.

- It was observed that many reform mandates post crisis are **not driven by IOSCO but handed down by the G20 and FSB**. This raises the question of what are the objectives of these reforms – to tackle systemic risk or to protect investors? In the past, IOSCO's focus has been on investor protection but over the past few years, systemic risk has been on the agenda and seems to prevail over other agendas, despite the impact on cost to firms and the end user. Participants believed that **IOSCO should think about its place in this process and relay this concern to the FSB**.

  The Chair commented that IOSCO's agenda, particularly after the LIBOR, London whale and the current Forex incidents, have begun to move back to conduct issues, which is the traditional focus of IOSCO. The benchmarks standard is a good example. However, there is no guarantee that IOSCO standards will not be "gold plated" or made even more rigorous in other jurisdictions. This is because IOSCO standards are not legally binding as IOSCO is not based on any treaty.

  IOSCO can only persuade through peer pressure although there is the Assessment Committee that looks at implementation of IOSCO principles and standards. The main legal power is based on national law or regional law, such as the EU. As such, the main dilemma in trying to address cross border issues is that national regulations which are introduced before or after the IOSCO standard is introduced are bound to differ. This makes effective harmonization difficult.

The Chair also made the point that regulation can be divided into addressing (i) systemic issues (eg. OTC derivatives) and (ii) investor protection. These objectives are not mutually exclusive. When it comes to dealing with systemic risk issues, regulators tend to be more conservative and appear to adopt a more local rather global approach. IOSCO as a global body has traditionally been more focused on investor protection and conduct and that the TF is looking at ways to reduce friction in cross border approaches.

- Participants were generally in agreement that the Task Force on Cross Border Regulation has a realistic mandate and a number encouraged **Asian regulators to come together and present a more unified voice to the US and EU**.

- It was emphasized that in terms of cross border regulation, there are 3 distinct blocks (US, EU and Asia). From an Asian perspective, intermediaries feel they are squeezed in the middle between US and EU as it is on the receiving end and has to reconcile the differences in EU/US regulation. It is important for regulators to **understand the differences between markets** e.g. business conditions, macroeconomic environment and legislative processes which often alter what the final regulations may look like. This causes difficulty in compliance for firms in Asia. One participant took the view that it is better to have one set of consistent rules (that may not even be optimal) that everyone follows.

- Participants suggested that for regulatory initiatives that have a cross border impact, regulators should **engage in discussion with the industry at a much earlier point**, before the consultation stage. Enough time should also be given to regulators and industry to evaluate the proposed initiatives and bring out any concerns. International principles should also be reviewed after a period of item and on a regular basis to see if they are fit for purpose.

- IOSCO could **come up with a procedural content regarding what aspects regulators should consider before implementing cross-border regulations.** This may include relevant internationally-agreed standards which should be looked at, and other considerations such as the extraterritoriality impact of the proposed regulations to overseas jurisdictions, minimum requirements on the consultation process, etc. Implementation of the proposed regulations would still be a national decision.

- IOSCO could **act as an information platform** where questions and answers regarding the development and implementation of new cross-border regulations were uploaded.

- IOSCO should take a firmer stance and **clarify what constitutes equivalence assessments and substituted compliance**. Firms are encountering difficulty in trying to comply with 2 sets of conflicting extraterritorial regulations from US and EU. There is also **a need for stronger cooperation between home/host regulators** on market misconduct issues.

- There seems to be a trend of more **high level principles** being introduced by standard setters **without deeper discussion on outcomes** based objectives.

There should be **more dialogue by regulators around supervision and conduct**.

- Participants also raised the issue of regulators not keeping to scheduled implementation timing and constantly tweaking the rules which makes it very difficult for firms to comply. **Clarity of timing** is very important for firms.

- In response to the question as to why do regulators keep changing the rules, one participant ventured that this was because (i) regulatory priorities and also the need for lead time to get the message across to the industry and (ii) the longer regulators delay implementation, the pressure will be on firms to comply.

- In terms of industry initiatives on proposing desired outcomes (investor protection, manage risks etc) a view was put forward that a key challenge for the industry is **whether the regulators will take up any suggestions or proposals made by the industry**, particularly banks. This may be one of the reasons why there are few examples of industry working with regulators on standards over the past 5 or 6 years. **One area where the industry has come together is in retail structured products where it had done work on Key Fact Statements and had thought about the desired standards**.