REGULATION OF REMOTE CROSS-BORDER FINANCIAL INTERMEDIARIES

TECHNICAL COMMITTEE
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I. Introduction

In March 2001, the IOSCO Technical Committee requested that its Standing Committee on the Regulation of Financial Intermediaries ("SC3") explore the issues related to the cross-border licensing of market intermediaries (but not including intermediaries that provide solely investment advisory services).[1] This request grew out of a recognition that the globalization of financial services has led to growth in cross-border activities on the part of financial intermediaries. This growth, in turn, has led many regulators to evaluate the application of their local rules to remote foreign intermediaries. The explosive growth in online (Internet) brokerage activity also increased the interest in regulatory responses to cross-border transactions. The Technical Committee asked SC3 to consider these issues as they relate to the *IOSCO Objectives and Principles of Securities Regulation*.

As part of its work, SC3 identified challenges that regulators face in applying IOSCO principles to market intermediaries that provide cross-border securities services in a regulator's jurisdiction from remote locations. Its members also drafted and answered a survey concerning the manner in which jurisdictions regulate such services.[2]

This report identifies and discusses, based principally on the survey results,[3] the factors that countries consider in determining how to regulate cross-border service providers that do not have a physical presence within their borders. For example, jurisdictions may consider the characteristics of the investor (e.g., institutional versus retail investor), the nature of the access (e.g., directly or through a local intermediary), and/or the type of the security traded (e.g., derivative rather than common stock). Some jurisdictions also consider the nature of the home regulation of the firm that seeks remote access. The decision to impose local requirements in addition to the requirements imposed by the foreign jurisdiction where the intermediary is physically located (the home jurisdiction) depends on considerations relating to the goals of investor protection, efficient capital markets, and the appropriate balance between these two. This report is intended to provide a reference for jurisdictions that face issues related to application of domestic regulations to foreign financial intermediaries that provide financial services in those jurisdictions without a physical presence. Part II of this report identifies the goals that jurisdictions seek to achieve through domestic regulation of financial intermediaries, ties those goals to the application of the IOSCO core principles and objectives, and lists some of the means used to meet those goals.

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1 For the purposes of this paper, the licensing of cross-border services refers to services provided to a jurisdiction from a location outside of that jurisdiction (i.e., no office or employees in the local jurisdiction). Note, however, that one jurisdiction limits the definition of cross-border services to those transactions effected through a local office of a foreign intermediary. Under this perspective, there cannot be "cross-border" transactions unless the foreign intermediary has a local office.

2 The general survey that preceded this paper addressed regulatory jurisdiction, detection of cross-border financial activity, regulatory co-operation, and customer protection (including investor compensation and insolvency).

3 The survey results are available on the members-only portion of the IOSCO website.

Part III outlines the two primary approaches that jurisdictions (survey respondents) currently follow in determining whether to apply domestic regulations to foreign financial intermediaries without a physical presence in their jurisdictions.

II. Regulation of Cross-Border Activity

A. Regulatory Goals

The 1998 IOSCO Objectives and Principles of Securities Regulation are based on three fundamental objectives: (1) the protection of investors, (2) promotion of fair, efficient, and transparent markets, (3) and the reduction of systemic risk. In the case of financial intermediaries, jurisdictions achieve these fundamental objectives through regulatory systems created to meet specific regulatory goals that are linked to the different activities of the intermediaries. These goals include:

- Safeguarding of assets,
- Effective communication between firms and clients,
- Qualified service providers (fit and proper including honesty, competency and financially sound characteristics),
- High standards of integrity and fair dealing in providing services,
- Stability of financial markets,
- Reliable recordkeeping,
- Adequate resources, procedures, enforcement, and
- Enforceable rights.

B. Means Used to Achieve Goals

Regulators use a variety of means to achieve their goals. The IOSCO principles delineate some of the standards that regulators should consider to reach those goals. In particular, the Commentary to the IOSCO Principles specifies that jurisdictions should grant licenses to market intermediaries only if applicants meet certain minimum entry standards that indicate that the intermediaries are qualified (fit and proper) to conduct business. These standards address the following: appropriate knowledge, resources, skills, ethical attitude, capital, standards of conduct, and adherence to procedures for the proper management of risks associated with the business of the market intermediary.[4]

The Principles also discuss conduct of business rules and other prudential requirements.[5] According to the Commentary, the management of a market intermediary should bear primary responsibility for the maintenance of appropriate standards of conduct and adherence to proper procedures by the whole firm. The Commentary identifies the following business of conduct standards to which a financial intermediary must adhere: integrity and diligence; written contract of engagement that sets out the intermediary's responsibilities to the customer; appropriate information about customers and for customers; proper protection of customer assets; high standards of market conduct; operational controls; maintenance

[4] Sections 12.3 and 12.5 of the Commentary to the 1998 IOSCO Objectives and Principles of Securities Regulation (the "Commentary").

[5] Section 12.5 to the Commentary.

of proper accounting and applicable records; compliance with all relevant legal and regulatory requirements; appropriate segregation of key duties and functions; avoidance of conflicts of interests; and clear policies on proprietary trading.

The following table identifies the goals described in Part A and possible means (regulatory requirements), as reflected in the survey results, for achieving them.

Goals	**Some Means of Achieving**
Safeguarding of assets	Custody, segregation, calculation and identification of customer assets, audit requirements, and special wind-up procedures.
Effective communication between firms and clients	Disclosure requirements, account opening documents, confirmations, ongoing account statements, written contracts of engagement, application of know-your-client and understanding of investment objectives to determine suitability of investments.
Qualified/fit and proper service providers	Proficiency, minimum entry standards, probity qualifications, minimum capital requirements, risk management, margin, audit and information filings, and statutory disqualification (for example, felony conviction).
Stability of financial markets	Sufficient/appropriate (liquid) capital, insurance, complaint handling arrangements, market supervision, effective clearance and settlement and information filings.
Reliable, secure and relevant information about activities	Books and records, procedures and controls, and adequate systems.
Appropriate resources and procedures	Implementation of appropriate procedures and controls, employment of risk management systems (including, in particular, details of how the applicant intends to address and manage potential conflicts of interest), maintenance of sufficient/appropriate (liquid) capital, and performance of audits.
Enforceable rights	Submission to jurisdiction, access to dispute resolution, compensation for misappropriated or missing customer funds and securities, customer documents in customer's language, and requirements concerning where assets must be held.
Adequate enforcement	Sufficient powers of investigation and enforcement, sufficient resources, and active use of powers.

When implementing the regulatory goals and means set out in the table above, a regulator often undertakes a cost-benefit analysis of new regulations. The regulator

conducts this analysis to facilitate an understanding of the financial and other costs of the proposed regulation to the intermediary as compared to the benefits the regulation is expected to produce for investors and other market participants.

Although they share common regulatory goals, survey respondents may differ in how they enforce the regulatory requirements and thereby achieve these goals. These differences stem both from the scope of the respondents' legal authority over domestic financial markets and from the resources available to devote to enforcement. For example, some jurisdictions have both civil and criminal power to enforce regulations pertaining to financial intermediaries, while others lack either civil or criminal enforcement power. Moreover, the greater the resources, the more rigorously a regulator can enforce the pertinent requirements.

Similarly, survey respondents differ in their approaches to oversight of compliance with local requirements. Some jurisdictions devote significant resources to compliance matters, while others either lack resources for such matters, choose to utilize their resources for other issues, or lack certain oversight authority. The same is true of inspections, which are closely related to compliance. Inspections help to ensure that financial intermediaries comply with relevant requirements. Again, some jurisdictions have established inspection regimes for financial intermediaries. Other jurisdictions, however, lack the resources to conduct inspections, do not devote resources to inspections, or lack certain authority to conduct inspections.

Jurisdictions also vary in their use of self-regulatory organizations ("SROs") to help them achieve regulatory goals. SROs generally are private-sector organizations that help to enforce local requirements related to financial intermediaries. Regulators, thus, can use SROs to leverage the resources available to them in performing their regulatory functions. Some survey respondents, including some members of the European Union ("EU"), do not utilize the SRO regulatory model.

Finally, the respondents to the survey apply different business conduct rules to financial intermediaries that operate within their jurisdictions. The EU is perhaps the best example of this. A financial intermediary from one EU member state may provide services in any other EU member state without registering/obtaining a license from the host state. The financial intermediary, however, must comply with the business conduct rules of each EU member state in which it provides services.

C. The Purpose of Linking Means and Goals

The table above illustrates some of the means that the survey respondents use to meet their regulatory goals and objectives when regulating cross-border service providers that do not have a physical presence within their borders. It provides regulators with a resource to use when issues related to cross-border activities of financial intermediaries arise. Neither this table, nor this report more generally, however, is intended to prescribe solutions or to circumscribe a specific methodology for approaching such issues.

III. Two Primary Approaches to Facilitation of Cross-border Transactions

This paper assumes, as a base case, that foreign intermediaries that provide services in a local jurisdiction generally would be subject to the local jurisdiction's requirements. The survey results, however, reveal that many jurisdictions exempt foreign intermediaries from certain regulations under specific circumstances. Countries tend to fall somewhere on a continuum from no exemption to full exemption of foreign intermediaries from local requirements.

Political considerations also may influence whether particular types of cross-border activities are exempt from local requirements. For example, recent amendments to Australia's financial services laws specifically contemplate recognition of overseas market operators and service providers. The intent of the legislation is to allow greater access to Australian users of such markets/services without undermining key market integrity and consumer protection outcomes.

Some jurisdictions apply local requirements in all, or nearly all, circumstances. The United States Securities and Exchange Commission ('SEC") falls into this category. In addition, some countries, such as Mexico and Japan, require foreign intermediaries to have a presence in the country. This essentially prohibits access to remote cross-border services.

Other jurisdictions exempt foreign financial intermediaries from certain requirements depending on the regulatory goals that the intermediaries' activities implicate. For example, Ontario (Canada) has a registration category for international dealers. An international dealer may provide limited services to sophisticated investors, but is subject only to minimal local requirements.

Still other jurisdictions fully exempt foreign intermediaries from many, or all, local requirements if the regulator in the host jurisdiction has concluded that the intermediaries' activities do not raise customer protection concerns under the relevant circumstances. For example, some jurisdictions, such as Japan and Hong Kong, do not require licensing if the intermediary has not solicited customers.

The survey results show that those jurisdictions that provide some relief from requirements follow two general approaches to determine if local requirements will apply to a foreign market intermediary that engages in cross-border transactions. These approaches rely upon: (1) the sophistication of the investor and (2) unilateral or mutual recognition. Some jurisdictions utilize both of these approaches when considering whether to apply local requirements to foreign intermediaries.

A. Sophistication of the Investor Approach

Some jurisdictions do not apply all local requirements to foreign intermediaries that engage in cross-border transactions with sophisticated investors from the host jurisdiction. This system recognizes that certain highly sophisticated, well-capitalized investors do not need the complete protection of securities regulations under certain circumstances. The United States SEC, for example, relies upon the sophistication of the investor in allowing certain foreign intermediaries to

conduct limited securities activities in the United States under Rule 15a-6[6] without registering with the SEC as a broker-dealer. The SEC does not apply all of its regulations (registration requirements, in this case) to foreign broker-dealers that engage in securities transactions with these sophisticated investors under the conditions specified in Rule 15a-6. Note that the SEC does not evaluate a foreign intermediary's regulatory regime to determine if the exemption applies. *See Appendix "A" for additional details on this approach*.

In Ontario (Canada), a foreign financial intermediary may be recognized as an "international dealer" and, thus, may act as a market intermediary in Ontario without meeting full domestic licensing requirements. An "international dealer" primarily sells securities of foreign issuers, generally to designated institutions, as that term is defined under the Securities Act (Ontario).

B. Unilateral and Mutual Recognition Approaches

Some jurisdictions utilize a system of unilateral or mutual recognition to decide whether to apply local regulations to a foreign intermediary. Under a unilateral recognition system, a jurisdiction generally will not apply local requirements to a foreign intermediary if the home regulatory regime to which that intermediary is subject meets certain investor protection criteria. Unilateral recognition does not require reciprocity on the part of the foreign regulator with respect to intermediaries from the local country conducting business in the foreign jurisdiction.

A mutual recognition system is similar to a unilateral recognition system in that the "access" jurisdiction recognizes the adequacy of a foreign intermediary's "home" regulation (and thus permits the foreign intermediary to operate within its borders without complying with local regulations), but it requires reciprocity for its own intermediaries from the home regulator. Under this type of system, each jurisdiction recognizes that the other's regulatory regime provides the necessary investor and market protections.

Australia is an example of a jurisdiction that employs a unilateral recognition system. The Australian Securities & Investments Commission ("ASIC") relies upon a "sufficient equivalence of regulatory outcomes" test to determine whether to apply Australian securities laws and regulations to a foreign intermediary. This test involves an examination of information that the applicant (the foreign intermediary) provides, together with information that ASIC possesses, including IOSCO reports/surveys and ASIC's experience of co-operation with the applicant's regulator. If the examination indicates that a foreign intermediary's regulatory regime would, in ASIC's view, provide Australian investors with protections sufficiently equivalent to those that investors would receive under Australian securities laws and regulations, ASIC may not require the foreign intermediary to obtain a license from ASIC to provide certain services to certain investors in Australia. An exemption of this kind normally will be conditioned upon, among other things, the foreign intermediary's agreement to engage a local agent for service of process and to submit to the non-exclusive jurisdiction of the Australian courts. *See Appendix "A" for additional details on the Australian regime.*

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[6] Rule 15a-6 was promulgated under the Securities Exchange Act of 1934.

In addition, the United States Commodity Futures Trading Commission ("CFTC") Rule 30.10 allows persons located and doing business outside the United States, who are subject to a comparable regulatory framework in the country in which they are located, to seek an exemption from registration as a futures commission merchant (that is, a broker), and certain other CFTC requirements. When the Commission grants an exemption pursuant to Rule 30.10, persons located and doing business outside the United States may solicit or accept orders directly from United States customers for foreign futures or options transactions without registering under the Commodity Exchange Act ("Act"). A petition for exemption pursuant to Rule 30.10 is typically filed on behalf of persons located and doing business outside the United States seeking access to United States customers by a foreign government agency responsible for the implementation and enforcement of a regulatory program or by a foreign SRO. A petitioner who seeks an exemption pursuant to Rule 30.10, based on substituted compliance with a non-United States regulatory framework that is comparable to the Act and rules thereunder, must set forth the comparable rules applicable in the jurisdiction in which that person is located and present a factual basis for a finding of comparability and the reasons why the policies and purposes of the Commission's regulatory program are met, notwithstanding any differences of degree or kind in the petitioner's regulatory program. *See Appendix "A" for additional details.*

The CFTC issued its first 30.10 exemption to the Sydney Futures Exchange in November 1988. Since that time, the CFTC has granted relief to 16 other foreign market authorities. As of December 2002, 159 foreign brokers operate under the exemption. There have been no CFTC enforcement actions based on violations of the 30.10 Order. Moreover, the National Futures Association, which verifies the fitness and representations made by firms applying for 30.10 relief, reports that, to date, there have been no enforcement or arbitration actions against any of the foreign brokers granted 30.10 relief. *See Appendix "A" for additional details*.

The European Union ("EU") relies upon a system of "mutual recognition of authorization and of prudential supervision systems," called the "EU Passport," that includes harmonization of prudential requirements. Under the EU Passport, a financial intermediary from one EU Member State may operate in any other EU Member State. As a result of the harmonization of prudential requirements, the intermediary is subject only to the prudential regulation of its home state, but must comply with local business conduct rules.

The prudential rules cover matters such as administrative and accounting procedures, the safeguarding of investors' funds and other assets, the structuring and organization of firms so as to minimize the risk of clients' interests being prejudiced by conflicts of interest, and other matters. The rules of conduct cover areas such as the duty of investment firms to act honestly and fairly, to act with due skill, care and diligence, and to make adequate disclosures to clients, among other areas. The implementation of the rules of conduct and the supervision of firms' compliance with them are the responsibility of the Member State in which a service is provided. This is an exception to the general application of the principle of Member State supervision.

Another component of "the essential harmonization that is necessary and sufficient to secure the mutual recognition of authorization and of prudential supervision systems" is the establishment of common standards relating to capital and risk requirements.

An EU firm must comply with certain home-host country notification formalities. To this end, the competent authorities of the home Member State must notify the competent authorities of the host Member State of the intention of an investment firm established in the home country's territory of the former to provide cross border services in the host Member State.

The competent EU member authorities must ordinarily authorize the provision of investment services in their jurisdictions if the registered office of the institution is not in a Member State of the EU ("non-EU financial intermediary"). Such an intermediary (including subsidiaries, branches or firms without physical presence) is then subject to the licensing and registration requirements of the EU country in which it conducts investment services and is subject to full EU supervisory regulation.[7]

There is no EU-wide recognition of non-EU foreign regulatory regimes. However, some EU countries may in certain cases rely upon unilateral or mutual recognition of non-EU financial intermediaries, without applying a formal authorization process. The number of non-EU intermediaries permitted to operate on a cross-border basis in certain EU jurisdictions in this informal manner is quite large in some sectors.

C. Other Factors: Solicitation, Financial Instruments, Disclosure, and Submission to Jurisdiction.

Some jurisdictions do not follow, or do not follow exclusively, the two primary approaches outlined above to determine if local requirements should apply to a foreign intermediary. These jurisdictions consider other factors in addition to, or to the exclusion of, those identified in the primary approaches. For example, certain jurisdictions do not apply local requirements to a foreign intermediary if a domestic investor contacts the foreign intermediary, on an unsolicited basis, to effect a transaction on a foreign market.[8] Japan and Hong Kong provide exemptions based on lack of solicitation. Furthermore, some jurisdictions consider the type of financial instrument offered in determining whether to apply local requirements. That is,

[7] A regime similar to the EU passport is under consideration in Canada for dealers or advisers who want to operate in more than one jurisdiction in Canada. The local securities regulators in Canada have proposed a system that relies on the home jurisdiction to grant the license to carry on business in any jurisdiction that participates in the system, but requires the dealer or adviser to comply with local conduct requirements. The licensing requirements applied by the local jurisdiction include completion of industry courses, capital requirements and insurance (fit and proper requirements). The conduct requirements are the rules imposed on dealers or advisers to ensure that the intermediary acts in a fair and appropriate way towards its clients. Such conduct requirements include supervision, prudent business practices, conflict disclosure, segregation of assets, and fair allocation of trading opportunities. It is intended that the system will be implemented in Canada through a national policy instrument that will set out how the process works.

[8] It is unclear if this outcome would change if the transaction effected involved a financial instrument from a corporation domiciled in the investor's country of residence.

transactions in certain instruments may subject a foreign intermediary to local requirements, while transactions in other instruments may not.

Singapore is an example of a jurisdiction that utilizes a combination of one or more of the two primary approaches and other factors. Specifically, Singapore considers the nature of solicitation, undertakes an evaluation of the foreign regulator, and considers the sophistication of the investor when determining whether to apply local requirements (including licensing requirements) to foreign intermediaries engaging in regulated activities in Singapore from outside Singapore. *See Appendix "A" for examples*.

III. Conclusion

Regulators share many of the same regulatory goals related to financial intermediaries. They implement these goals through licensing and conduct requirements. Many jurisdictions, however, provide full or partial exemptions from the full licensing/registration and other, local requirements for foreign intermediaries. In general, these jurisdictions rely upon one or both of the following two approaches to determine if a foreign intermediary must comply with local regulations: (1) an evaluation of the sophistication of the investor or (2) some form of unilateral or mutual recognition. These exemptions may be responses both to political considerations and the increasing globalization of financial services.

APPENDIX A

1. Australia

Commencing on 11 March 2002, the *Financial Services Reform Act 2001* (FSRA) amended Australia's *Corporations Act 2001* to introduce a regulatory regime that deals with a broad range of financial products and services (i.e. beyond securities and futures). Part 7.6 of Chapter 7 of the *Corporations Act 2001* has a general requirement, in s.911A(1), that if a financial services provider is 'carrying on a financial service business' in Australia then it will need an Australian Financial Services (AFS) licence.

Recognition of cross border regulation of foreign financial services providers

There are three key examples of how the post-FSRA regime contemplates financial activity by overseas regulated-providers in the Australian jurisdiction and seeks to recognise their regulation in their home jurisdictions. First, s.911A(2)(h) anticipates relief from the AFS licensing requirements for a foreign intermediary that provides services only to wholesale clients in Australia and where ASIC recognises the relevant overseas regulator of the intermediary. Second, regulation 7.6.01(n) provides relief for an overseas dealer for the provision of services to Australian residents where an Australian licensee arranges for the overseas dealer to provide those services. Third, s.911A(2)(l) provides ASIC with a general exemption power to grant entities relief from the AFS licensing regime. Using an earlier version of this general power, ASIC has provided licensing relief for operators of foreign collective investment schemes.

Against this legislative background, ASIC has developed a series of policy proposal papers (“PPP”) and policy statements ("PS") to facilitate the provision of cross-border financial services. This report focuses on ASIC's PS 176 *Wholesale Foreign Financial Services Providers*. In addition, in November 2002 ASIC released a set of Principles in relation to cross-border financial services regulation; these Principles formed the basis for the development of the PPPs and PSs referred to above.

Principles for cross-border financial services regulation (November 2002)

ASIC’s Principles for cross border financial services regulation seek to balance the facilitation and availability of foreign financial services in Australia with ensuring adequate investor or market protection. These Principles are not based on mutual recognition.[9]

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[9] The Principles are:

Principle 1 - ASIC recognises foreign regulatory regimes that are sufficiently equivalent to the Australian regulatory regime, in relation to the degree of investor protection, market integrity and reduction of systemic risk that they achieve

Principle 2 - ASIC gives the fullest possible recognition to sufficiently equivalent foreign regulatory regimes

Principle 3 - ASIC must have effective co-operation arrangements with the home regulators of foreign facilities, services and products available in Australia

The Principles provide guidance for assessing the nature of the regulation of an overseas regulatory authority by using an 'equivalence test' (see Principles 1 and 7 – 10). This test is flexibly applied in each of the PPPs mentioned above.

ASIC PS 176 - Wholesale Foreign Financial Services Providers

This policy is designed to facilitate entry into the Australian market by a foreign intermediary that wishes to provide financial services only to wholesale clients. The policy outlines when ASIC may recognise an overseas regulatory regime because it meets a regulatory 'equivalence test.' The relevant 'equivalence test' involves the overseas regulatory regime delivering sufficiently equivalent regulatory outcomes to the Australian regulatory regime. If an overseas regulatory regime is recognised, a foreign financial service provider may be granted relief from the AFS licensing requirements. This policy also requires that a service provider may only be granted relief where ASIC has effective co-operation arrangements with the overseas regulatory authority. Usually, effective co-operation arrangements will be in the form of an MOU or other documented understanding, although they may be supplemented by more informal arrangements.

2. The European Union

As part of its drive to achieve an internal market in financial services, the EU has established a framework of "mutual recognition of authorization and of prudential supervision systems, making possible the grant of a single authorization valid throughout the Community and the application of the principle of home Member State supervision … by virtue of mutual recognition, investment firms authorized in their home Member States may carry on any or all of the services covered by this Directive for which they have received authorization throughout the Community by establishing branches or under the freedom to provide services [on a cross-border basis]."[10]

Principle 4 - ASIC must be able to enforce the Australian laws that apply to foreign facilities, services and products

Principle 5 - Adequate rights and remedies must be practically available to Australian investors who access foreign facilities, services or products in Australia

Principle 6 - Adequate disclosure must be made of information that Australian investors may reasonably require to make an informed assessment of the consequences of any significant differences between the regulation of the foreign facilities, services or products and the regulation of comparable Australian facilities, services and products

Principle 7 - An equivalent regulatory regime is clear, transparent and certain

Principle 8 - An equivalent regulatory regime is consistent with the IOSCO objectives and Principles of Securities Regulation

Principle 9 - An equivalent regulatory regime is adequately enforced in the home jurisdiction

Principle 10 - An equivalent regulatory regime achieves equivalent outcomes to the Australian regulatory regime. (Examples of equivalent outcomes are included for financial markets, clearing and settlement, financial services and the offer of financial products)

[10] Preamble to Council directive 93/22/EEC of 10 may 1993 on investment services in the securities field, known as the Investment Services Directive, or "ISD."

This framework is underpinned by "the essential harmonization necessary and sufficient to secure the mutual recognition of authorization and of prudential supervision systems." The "essential harmonization necessary" is specified partly in the Investment Services Directive itself. Article 10 specifies that: "Each home Member State shall draw up prudential rules which investment firms shall observe at all times." These rules cover matters such as administrative and accounting procedures, the safeguarding of investors' funds and other assets, the structuring and organization of firms so as to minimize the risk of clients' interests being prejudiced by conflicts of interest, and other issues. Article 11 of the ISD further requires that "Member States shall draw up rules of conduct which investment firms shall observe at all times [and that] must be applied in such a way as to take account of the professional nature of the person for whom the service is provided." These rules of conduct cover areas such as the duty of investment firms to act honestly and fairly, to act with due skill, care and diligence, to make adequate disclosures to clients, among other things. The implementation of the rules of conduct and the supervision of firms' compliance with them are the responsibility of the Member State in which a service is provided. This is an exception from the general application of the principle of home Member State supervision.

Another component of "the essential harmonization that is necessary and sufficient to secure the mutual recognition of authorization and of prudential supervision systems" is the establishment of common standards relating to capital and risk requirements. These common standards are set out in Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investments firms and credit institutions.[11] This directive adopts "measures to coordinate the definition of the own funds of investment firms, the establishment of the amounts of their initial capital and the establishment of a common framework for monitoring the risks incurred by investment firms."

The preambles to both the ISD and the CAD make clear that Member States may establish rules stricter than those provided for in the directives. In other words, the directives themselves represent the minimum "harmonization necessary for the achievement of mutual recognition within the framework of the internal market."[12]

3. Singapore

In determining whether local regulations apply, Singapore generally considers: (1) whether there is a substantial and reasonably foreseeable effect in Singapore and (2) the nature of the solicitation, including factors such as the use of active communication devices to target persons in Singapore, the presence of disclaimers, and whether the offer of services is priced in Singapore dollars.[13]

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[11] Known as the Capital Adequacy Directive, or "CAD."

[12] Extract from the preamble to the CAD.

[13] MAS will be issuing guidelines on the regulation of cross-border activities in the latter part of 2003.

Entities carrying out regulated activities in Singapore need to be licensed by MAS. However, there are provisions under the Securities and Futures Act ("SFA") to allow foreign intermediaries to engage in regulated activities in Singapore under approved arrangements with local affiliates, without having to be separately licensed. The provision of a financial service in Singapore may entail multiple processes that correspond to more than one regulated activity. This provision allows for some regulated activities in this chain to be provided from Singapore, and others from outside Singapore by one or more entities that are not regulated by MAS.[14]

In addition, the SFA makes provisions for foreign intermediaries – which are not licensed by MAS – to offer collective investment schemes to Singapore investors without having to comply fully with the local requirements. Considerations include the sophistication of the investor, and whether the foreign jurisdiction in which the intermediary operates accords equivalent protection to investors.

4. United States CFTC

Appendix A to Part 30 articulates standards to be used by staff in assessing whether a foreign regulatory system is comparable. These standards involve inquiry into the following areas: (1) registration, authorization or other form of licensing, fitness review or qualification of persons through which customer orders are solicited and accepted; (2) minimum financial requirements for those persons that accept customer funds; (3) protection of customer funds from misapplication; (4) recordkeeping and reporting requirements; (5) minimum sales practice standards, including disclosure of the risks of futures and options transactions and, in particular, the risk of transactions undertaken outside the jurisdiction of domestic law; (6) compliance; and (7) information-sharing.

5. The United States SEC

The United States SEC generally does not rely upon unilateral or mutual recognition to determine whether to apply local requirements to foreign intermediaries. Thus, the United States SEC applies local requirements unless specified exemptions apply.

The SEC, pursuant to Rule 15a-6, promulgated under the Securities Exchange Act of 1934, permits foreign intermediaries to engage in certain, limited securities activities in the United States without registering as a broker-dealer. Most exemptions in the Rule are designed to permit unregistered foreign broker-dealers to deal with certain sophisticated counterparties without being required to register with the Commission. Rule 15a-6 identifies two types of sophisticated counterparties. The first is a "U.S. institutional investor," which the Rule defines to mean registered investment companies, banks or savings banks, insurance companies, or certain other United States entities. The second is a "major U.S. institutional investor" which includes U.S. institutional investors that have assets, or assets under management, in excess of $100 million.

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[14] For example, a Singapore customer can put through a trade order through a local entity, but the account opening, trade execution, confirmation and settlement can be done overseas, as may be the custodial arrangement for the securities (a regulated activity under our SFA), as well as any securities financing (another regulated activity).

The Rule provides a conditional exemption from registration for a foreign broker-dealer that directly distributes its research reports to major U.S. institutional investors provided that (1) the report does not recommend that the recipients use the foreign broker-dealer to effect trades in any security, (2) the foreign broker-dealer does not initiate any follow-up contact with the recipients of the report, and (3) the foreign broker-dealer does not otherwise induce or attempt to induce the purchase or sale of any security by the recipients of the report. A foreign broker-dealer, however, may initiate follow-up contact with the major U.S. institutional investor, if such conduct is also exempt under the Rule.

The Rule provides exemptions for foreign broker-dealers who, from outside the United States, effect, induce, or attempt to induce transactions with or for U.S. institutional investors and major U.S. institutional investors, as these terms are defined above, subject to certain conditions. First, in the case of a U.S. institutional investor, a registered representative, that is, the SRO-registered sales employee of the intermediating registered broker-dealer, must participate in all communications and contacts between the foreign broker-dealer and the U.S. institutional investor. Participation of a registered representative is not required in the case of a major U.S. institutional investor.

Second, the rule provides that all transactions resulting from the solicitations must be effected through a registered broker-dealer. The transactions, however, may not be intermediated through a United States bank acting in a broker-dealer capacity. In general, the registered broker-dealer intermediating the transaction with the foreign broker-dealer must effect all aspects of the transaction except the negotiations.[15]

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[15] In 1997, the SEC staff granted no-action relief in response to a request from nine major U.S. broker-dealers (the "Nine Firms Letter"), stating that it would not recommend enforcement action if foreign broker-dealer affiliates of U.S. registered broker-dealers treated any entity, including an investment adviser not registered as such with the Commission, that owns, controls, or has under management in excess of $100 million in financial assets as a major U.S. institutional investor for purposes of Rule 15a-6. For purposes of the Nine Firms Letter, the term “financial assets” includes cash, money-market instruments, securities of unaffiliated issuers, futures, options on futures and other derivative instruments.