Mutual Recognition – The Example of MiFID

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This week, the SEC issued a press release stating that it was proceeding full steam ahead with mutual recognition. As discussed in prior columns, mutual recognition essentially permits foreign broker-dealers to sell securities to U.S. investors without registering as broker-dealers under U.S. law. The SEC's press release pointed out that this will mean different things in dealing with different countries and will require various rule changes and, in some cases, legislation to accomplish. I expect these proposals will be exceedingly controversial.

As we proceed, damning the torpedoes, into the brave new world of mutual recognition, much can be learned from the example of Europe. On November 1, 2007, the European Union adopted the final phase of the Markets in Financial Services Directive, known most commonly as "MiFID."

MiFID is a fascinating bit of legislation, adopted as it turns out, in four parts. MiFID is the latest attempt by the EU to establish a common system for regulating the trading of securities and futures. The EU's prior attempt, the Investment Services Directive (ISD), failed to achieve its objectives because many European nations required equity trading in securities issued in their respective jurisdictions to take place on their national securities exchanges. One of the primary objectives of MiFID was to break the stranglehold of the national securities exchanges over the trading of securities, thereby paving the way for an over-the-counter market in European securities. So, each of the 20 nations that have agreed to adopt MiFID have also agreed to loosen these restrictions.

In this brief column, we won't explore all of MiFID's various twists and turns – volumes have been already been devoted to this task. For our purposes, two points are worth noting. First, MiFID is essentially an exercise in mutual recognition. As a result, it provides some clues as to the likely result of mutual recognition in the United States. Second, the architects of MiFID very much intended that its adoption would lead to harmonizing European securities regulations with U.S. securities laws. As a result, in MiFID, we get a glimpse of how Europeans perceive U.S. securities laws, or at least what they think is important about them.

MiFID is a mutual recognition scheme because the twenty nations that have adopted it are sovereigns. The European Union (EU) is essentially a treaty among a group of nations, rooted in economics. MiFID is now a part of that treaty.

One of the important issues resolved by MiFID is how to regulate trading of securities occurring across the EU, when trading is done on a trans-European basis, rather than in the home country exchange. MiFID's answer is that the "home country" of an investment firm regulates all of its activities in the EU. This includes branch offices set up in another country (the "host country"). However, if the investment firm establishes a subsidiary entity, rather than a branch, then the host country regulates the subsidiary.

MiFID also establishes a common set of rules to deal with things like trade reporting, and most importantly, the treatment of clients. Member nations are forbidden to "gold plate" regulations by imposing higher standards in their jurisdictions.

There is no common regulator for the European Union. Each member nation's securities regulator belongs to the Committee of European Securities Regulators (CESR), but CESR only has advisory powers. So, nations, firms or individuals who believe that regulatory oversight has been improperly applied are required to take their grievances to the European Court of Justice.

Europe's example suggests that our own attempt at mutual recognition is likely to lead to three changes in the U.S. regulatory landscape. First, we are likely to adopt a common set of rules to govern the conduct of European broker-dealers that operate securities businesses in the United States that will be equivalent to the rules that will apply to U.S. broker-dealers operating in Europe. We will not be permitted to indulge in "gold-plating." Second, there will be a division of regulatory authority, so that some foreign broker-dealers operating in the United States will not be subject to regulation by the SEC. The SEC will, however, regulate the European activities of U.S. securities firms. Third, U.S. grievances against the workings of the system will have to be resolved by something along the order of an International Court of Justice. As presently constituted, this Court is not prepared to handle any significant volume of securities litigation.

It is difficult to conceive the political and cultural changes required to accomplish mutual recognition. Among many other things, the United States would be required to surrender a substantial part of its sovereignty, which runs counter to our fondness for unilateral action. The unpleasant alternative is to surrender our preeminence in the trading of securities and financial services to non-U.S. firms with a global reach.

U.S. businessmen have embraced globalization and dealt with its issues for decades. Now, we will have to see how our political system and our regulators adjust to the globalization of securities law itself.

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