Mutual Recognition

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Originally Published in *Traders Magazine* on February 14, 2008

http://www.tradersmagazine.com/news/100279-1.html

Last Friday and Saturday, much of this nation's securities bar, and representatives from leading accounting firms, made the annual pilgrimage to Washington DC to attend "SEC Speaks," a program organized by the Practicing Law Institute (PLI). Senior members of the SEC's staff marched to the podium, Division by Division, to describe what they have done in the past year and what they are working on presently.

The topics change from year to year, as well as the tone of the conference. In the wake of Enron and other scandals, the staff was aggressive in describing its efforts to protect investors. As the expenses involved in Sarbanes-Oxley compliance became more evident, the tone at SEC Speaks turned defensive, as the staff emphasized its desire to work with issuers and the accounting profession to reduce the compliance burden.

This year's theme is "mutual recognition." At its most essential level, this euphemism means that the SEC is considering ways to let foreign broker-dealers sell foreign securities to US investors with requiring those broker-dealers to register under the Exchange Act or become members of FINRA. The theory is that if we can become comfortable that a foreign jurisdiction does an adequate job of protecting investors in the home country, then we will not require broker-dealers regulated in that jurisdiction to comply with US securities laws. Bound up in mutual recognition is the concept of quid pro quo – the other jurisdiction, at a minimum, would have to allow US broker-dealers to sell US securities to its investors without requiring any additional compliance under the foreign regime.

This sort of thing raises obvious competitive issues. As anyone in the securities business knows, compliance costs are an increasingly important part of the expense side of the ledger. To the extent that a foreign broker-dealer has lower compliance costs, it will offer services at lower cost than its US counterpart. It has been argued that any differential on cost structures will be balanced by the remaining restrictions on broker-dealer activities – foreign broker-dealers will not be permitted to sell US securities to US investors, for example. However, this is a business where a penny or two per transaction separates the good business from the bankrupt, and the securities of many non-US issuers are a good alternative to US securities.

Will it work? To that question, it will be instructive to observe how 30 European nations deal with the Markets in Financial Services Directive (MiFID). Under MiFID, the home country regulator provides the supervision for business activities

conducted by securities firms in another European nation (the "host country"). When a securities firm sets up a branch in a host country, the regulatory responsibilities are shared between home and host countries. To facilitate sharing, the host country is required to permit the home country regulator to enter its borders to conduct branch office inspections. When that branch is a subsidiary, it is entirely regulated by the host country. Confused?

Shared securities regulation in the United States generally has not been a happy experience. Regulatory confusion ultimately led to the formation of FINRA, the result of the merger of NYSE Member Regulation with the NASD. And, over the years, the trend has been to reduce the role of state regulators in securities regulation, Eliot Spitzer notwithstanding.

MiFID was officially installed last November. So, it remains to be seen how all of this will work in practice. It is nonetheless important to realize that the MiFID also harmonized the substantive securities laws of its 30 subscribing nations. Each nation may read the law a bit differently, but the words are the same. And each nation is prohibited under MiFID from imposing higher standards, a regulatory practice condemned as "gold plating." The European Court of Justice is there to address complaints by European citizens that one of the 30 nations is over regulating.

The prohibition on gold plating is an important ingredient of any mutual recognition scheme. Where competitors are required to comply with different regulatory standards, setting aside differences in the competence of various regulators, one of them will be at an unfair competitive disadvantage.

This means, in my view, that mutual recognition is one step down the long winding road to a globally consistent system of securities regulation. And, it seems equally clear that this global system will not be achieved by the rest of the world adopting US securities laws. Instead, we will learn to live with some aspects of foreign regulation.

Is this a good idea? I don't know. Is it Un-American? Perhaps. Nonetheless, as night follows day, it is inevitable.