Commentary: The Difficulty of Global Securities Regulation

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The Panic of 2008 is a global disaster, affecting most countries in the industrialized world. Since human acts and omissions cause financial crisis – it is not an act of God – we expect that humans, particularly our elected officials, will determine its causes and take the necessary steps to prevent a recurrence.

That said, the solution to a global disaster is necessarily a global solution. But, there are no globally elected officials. The task of concocting a global solution is therefore complicated by the lack of any global system of financial services regulation, or for that matter any global governmental authority that can institute and enforce global solutions.

The SEC, for all its regulatory sins of commission and omission, recognized in the pre-crisis period that US securities regulations were being undermined by global market forces. It therefore took steps in the last few years before the crisis to harmonize European and US securities regulation, commenced discussions on harmonization with regulators throughout the industrialized world and entered into a number of enforcement understandings with many non-US regulators. Regrettably, the SEC's efforts were cursed by unintended negative consequences. A few examples are noteworthy.

The collapse of the five largest investment banks has been blamed on the broker-dealer holding company standards for regulatory net capital established in the last few moments of the SEC chaired by William Donaldson. Among other things, the new broker-dealer holding companies used Basel 1 standards for regulatory capital, which was the standard for banking regulatory capital formulated and adopted by the European Union. In this case, the SEC was responding to complaints by these regulated firms that their ability to compete on a global level was impaired by existing regulatory capital rules. The SEC's well-intended accommodation to European net capital standards, coupled with a relatively weak approach to supervision of these rules, contributed to the collapse of the US investment banking system.

Under the Cox administration, the SEC, in conjunction with the Fed, adopted portfolio margin rules for brokerage accounts with certain broker-dealer clients, moving away from the more rigid position requirements of then-current margin rules. This relaxation of standards was adopted because hedge fund clients of

broker-dealers were opening accounts in Europe to take advantage of relaxed margin requirements.
Ironically, it can be argued that relaxing the margin rules served to protect broker-dealer customers. European brokerage accounts were not protected by US customer protection rules. As a result, Lehman customers in London are still waiting for the administrator to decide how much will be left of their accounts when the process is finally completed. In contrast, no US brokerage customer lost a dime in the Lehman insolvency. This accommodation to global standards therefore met with mixed results. It contributed to the massive increase in leverage that ultimately caused the current financial crisis, but protected some US customers who otherwise would have ended up losing their assets in non-US brokerage accounts.

Also during the Cox administration, the SEC allowed foreign issuers with a class of securities registered in the US to employ IFRS, the European accounting standard, without being required to reconcile financial reports with GAAP. The change was necessary because European regulators threatened to require US issuers with stock listed on European exchanges to reconcile with IFRS. It is too early to tell whether or not this change will have a negative impact on the investing public.

All of these decisions were extremely controversial, but reflect the difficulty the SEC faces enforcing standards that are inconsistent with those of our major trading partners. Chairperson Schapiro has stated that she is reconsidering the decision to allow IFRS to replace GAAP as an accounting standard, but it is difficult to understand how she can resist the pressure that will be brought to bear by affected US issuers.

These difficulties are compounded by the fact that the European Union, while purporting to operate as a single market, does not have a single regulator. The European Union does not have an SEC, which is an independent agency charged with rule-making, interpretation and enforcement of US securities laws. Instead, the European Commission produces securities legislation, but each of the various member states of the European Union are responsible for its implementation, interpretation and enforcement.

In an effort to achieve consistent regulation, called “convergence,” the securities regulators of each member state participate in a College of European Securities Regulators (CESR). CESR does not have any regulatory authority. Its primary function is to advise the European Commission.

To get some idea how this works, imagine a world in which there is no SEC. Instead, federal securities law is interpreted, administered and enforced by the 50 state securities administrators. The National Association of State Securities Administrators (NASSA) is appointed to advise Congress and the White House on

securities regulation. The New York Stock Exchange is regulated by Attorney General Cuomo, while NASDAQ is regulated by the Maryland State Securities Commission. You would expect a large degree of inconsistency in the administration, interpretation and enforcement of the nation's securities laws. Inconsistency is the partner of uncertainty, which negatively impacts investment and capital formation.

While each member of the European Union has adopted securities regulations instituted by the European Commission, a process called "implementation," it is no surprise that wide variance exists in their interpretation and enforcement. Parties that believe any particular jurisdiction has gotten it wrong must make their case with the European Court of Justice. The natural reluctance of regulated entities to sue their regulator is an obvious obstacle to convergence.

The European system makes it very difficult for the SEC to harmonize regulatory standards with its European counterparts. For one thing, there is no single party with the authority to negotiate with the SEC. European-wide securities regulation is instituted by the European Commission. However, the European Commission is a foreign power, and diplomacy belongs to the State Department. It is most unlikely the SEC would ever be permitted to negotiate rule changes with the European Commission directly. The SEC might meet with CESR, but CESR has no authority to agree to anything. The member States cannot change regulations instituted by the European Commission. The SEC has been most successful entering into enforcement understandings with the securities authorities of various European member states, but even that is more of a patchwork quilt, rather than a consistent regulatory regime. In spite of superhuman efforts by the SEC, I am aware of no rule change reflecting any multi-lateral convergence of US and European securities regulation.

There is some political support within the European Union to change all of this in the interests of more consistent securities regulation across its member States. Recently, the European Commission appointed "The High-Level Group on Financial Supervision in the EU," composed of eight wise men, which received advice from banking and securities regulators and industry representatives. On February 25, 2009, the Group produced a report named after its Chairman Jacque de Larosière, which made recommendations for dealing with the current financial crisis and necessary regulatory changes for avoiding the next crisis.

The de Larosière report, among many other things, proposes transforming CESR into a new European Securities Authority (ESA). The ESA would operate as an independent agency with powers similar to those currently exercised by the SEC. The ESA would have the power to negotiate with non-European securities regulators to harmonize regulatory efforts on a global basis.

The de Larosière report admits that its proposal to establish an ESA is extremely controversial. Great Britain is especially reluctant to yield any of its power to interpret and enforce securities regulation within its boundaries. Other member States are also likely to balk at surrendering their prerogatives. European issuers have long viewed the SEC as a sort of bogeyman and can be expected to resist any attempt to establish anything like it within the European Union.

For all of these reasons, the European Commission published a decision on January 23, 2009, reestablishing CESR and emphasizing that "[CESR] does not have any regulatory powers at the [European] Community level." The decision is not strictly necessary. CESR lacks the funding necessary to be an effective regulator of much of anything.

As it remakes financial services regulation, the Obama administration and Congress are faced with some difficult choices. In an age of global communication and transport, if securities regulation is bolstered in the United States in a way that makes it less expensive to operate within the European Union, financial services firms and issuers will simply relocate, placing as much of their business as possible outside the United States.

We could respond by refusing to let foreign entities sell products in the United States unless they comply with our securities laws. Non-US issuers with a substantial US investor base would be required to register with the SEC, or be deprived of a US market for their products. Non-US broker-dealers would not be permitted to deal with any US institution or any of its affiliates.

This has never been tried. It is possible that access to the US market is so important to the rest of the world that when push comes to shove, most non-US issuers and financial services firms would be forced to register under US securities laws. On the other hand, this strategy may have the negative effects of depriving the US consumer of access to a wide range of products, including important pharmaceuticals and fast sports cars. As a matter of policy, it is difficult to argue that US securities laws should control international trade for that would amount to a very small tail wagging a very large dog.

Nonetheless, the alternatives are depressing. We can just ignore Europe and the rest of the world altogether, letting the financial services industry and other firms relocate if they are so inclined. Securities regulation would be enforced rigorously within our borders. This was the policy generally followed by the SEC for most of its history, leading to concerns about our ability to compete with the rest of the world.

Or, we can try to harmonize US securities regulation with Europe. At present, this would mean letting them lead the way. We would generally adopt European

policies when necessary and desirable to facilitate the ability of US financial services firms to compete with their non-US counterparts and the desire of US investors to invest in non-US securities. We would try to protect retail investors, but not much else. This was the regulatory policy generally adopted by the most recent SEC administrations. The current financial crisis demonstrates with force its folly.

The fact is that a global regulator of the financial services industry is essential to our prosperity. Nothing less will be sufficient.

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