

REGULATION

Inching toward reform

A proposal to reform the SEC's "foreign broker" rule is a good first step

■ BY JAMES LANGTON

CANADA'S NATIONAL SECURITIES regulation increasingly looks like an anachronism in financial markets that are increasingly global. Nevertheless, globalizing regulation is a task that's easier said than done. In the meantime, it may be the mundane reforms that inch us toward more efficient cross-border oversight.

Although many market players in Canada view national regulation as an unattainable ideal amid our doggedly fragmented system, the world's major capital markets are moving beyond national regulation. Countries in Europe, for example, have tried to transcend their national borders to create a more integrated European market.

More recently, the U.S. **Securities and Exchange Commission** has broached the idea of allowing freer access to its markets through a system of mutual recognition. In theory, countries with comparable regulatory regimes would allow firms to deal in each other's markets without requiring those firms to register in compliance with the requirements imposed in each jurisdiction.

For example, if Canada's regulatory regime was determined to be substantially similar to that of the U.S., Canadian firms would be permitted to deal with clients south of the border without registering in both countries.

Such a move would do away with much of the duplication of effort and resources that are currently expended by operating in both countries. The concept's proponents have suggested that mutual recognition could both improve market efficiency and enhance investor protection. In addition, it could pave the way for freer trade in securities, as the Canadian federal government has advocated.

Earlier this year, the SEC decided that it would make the first attempt at implementing mutual recognition. In late March, the SEC, the **Australian Securities and Investment Commission** and the Australian Treasury Department announced the launch of formal discussions in pursuit of a mutual recognition arrangement.

The decision came as a disappointment to Canadian market players, who had hoped the SEC would take the first crack at mutual recognition with its closest neighbour.

But Canada hasn't been left behind entirely. In late May, at the annual meeting of the **International Organization of Securities Commissions** in Paris, the SEC and the **Canadian Securities Administrators** announced that they were negotiating a "process agreement" that would lay out how talks on mutual recognition between Canada and the U.S. would proceed.

At the time, the SEC and CSA indicated that they intended to reach an agreement in mid-June. By mid-July, however, the regulators had not yet reached such an agreement — although they insist that talks are still going well.

There's nothing to indicate that either side is backing away from the concept of mutual recognition before the talks even get started. Such a process is expected to take a long time to consummate, and there will be plenty of opportunities to abandon the idea before throwing open the borders. It may simply be that it is summer, the season when vacations traditionally impede regulatory productivity. Moreover, financial markets have been exceptionally tumultuous in recent months, keep-

ing regulators busy as they play their part in ensuring the financial system's stability.

Nevertheless, the fact that the regulators have already missed a self-imposed deadline by a fair margin reinforces the perception that mutual recognition is probably a long way off — if, indeed, it is ever to be achieved.

In the meantime, though, the SEC has proposed a much more modest regulatory change that could give Canadian firms greater access to U.S. institutional clients almost immediately. In late June, it proposed reforms to its "foreign broker" rule.

Under the current rule, foreign brokers can claim "safe harbour," which allows them to deal — without registering — with U.S. institutional investors who have at least US\$100 million in financial assets. However, these dealings must include a U.S. broker as a "chaperone" on any phone conversations or in-person contacts between foreign brokers and U.S. clients.

The SEC is now looking to expand the safe harbour. Among other things, the proposed reform would essentially do away with the chaperone requirement; it would also lower the threshold for qualifying clients to those with US\$25 million to invest, effectively broadening the pool of potential customers for foreign brokers.

The SEC explains that it is proposing these changes — even though the current rule has worked well enough for the past 20 years — because increasing market globalization has made it necessary to revisit the rule.

"The pace of internationalization in secur-

ities markets around the world has continued to accelerate since we adopted [the foreign broker rule] in 1989," it says. "Advancements in technology and communication services have provided greater access to global securities markets for all types of investors. U.S. investors are seeking to take advantage of this increased access by seeking more direct contact with those expert in foreign markets and foreign securities."

Moreover, the SEC admits that the chaperone requirements "have been criticized as impractical and that they have been viewed as imposing unnecessary operational and compliance burdens."

Ian Russell, president and CEO of the Toronto-based **Investment Industry Association of Canada**, indicates that the Canadian industry is strongly in favour of the proposed changes. Although this does not supplant the goal of reaching a mutual recognition deal, it would certainly be a valuable interim step, expanding the range of clients Canadian firms could serve in the U.S. as well as making it administratively easier to do so.

"If the safe harbour were liberalized sufficiently," Russell says, "it could serve as a significant alternative to mutual recognition, especially in the shorter term. I think that, at the end of the day, you'd still want to work toward mutual recognition. But the appeal of [the proposed revision to the foreign broker rule] is that you could markedly improve Canadian dealers' access to the U.S. market in the intervening period, prior to getting mutual recognition."

The biggest beneficiaries, Russell suggests, would be the 40-odd institutional boutiques that would find it much easier to operate in the U.S. under the new rules. As it stands, most of the Canadian firms that serve institutional clients in the U.S. have already set

Modernizing the rules is a tangible step toward making U.S. markets more competitive

up affiliates in the U.S. to handle the chaperoning function. So, doing away with that requirement is probably not going to be a huge deal for these firms. Indeed, the SEC indicates that the rules as they stand are more of a burden on firms based in other time zones.

Initially, firms would probably maintain their affiliates to see how things work under the new rule, Russell says. But, in the longer run, some of the smaller firms may decide that with the expanded safe harbour, they can do away with their U.S. affiliates, thereby reducing their operating costs. Additionally, small Canadian firms that haven't wanted the hassle of dealing in the U.S. because of these requirements may decide to start.

The bigger change for Canadian firms, however, is probably the expansion of the list of clients that foreign firms can serve. IIAC is currently analysing the proposed reforms, Russell says, and will be discussing the proposal in-

ternally before deciding whether IIAC should support the SEC's proposed minimums or if it should push for an even lower floor on qualified clients.

The other big attraction of this proposed reform is its achievability. The SEC's commissioners approved its publication for comment unanimously. (Comments are due Sept. 8.) So, it does not appear to be controversial within the SEC. Nor does it require reciprocity or co-operation from foreign regulators. And, as Russell points out, it is a conventional rule-making initiative — unlike mutual recognition, which represents uncharted waters and, therefore, may prove tougher to realize.

Moreover, the SEC's proposed rule has the support of the U.S. financial services industry, despite the fact that it would probably mean more foreign competition for clients. The U.S. industry trade association, the Washington, D.C.-based **Securities Industry**

and Financial Markets Association, has come out in favour of the proposed changes.

"By opening up this two-decade-old rule for reform, the commission helps ensure that U.S. markets remain competitive instead of shackled by arcane and duplicative regulations written before the advent of e-mail or the Internet," said Ira Hammerman, senior managing director and general counsel of SIFMA, in a statement. "Modernizing how overseas brokers interact with U.S. investors is a tangible step forward in the movement to make the U.S. more competitive in the global marketplace."

Indeed, SIFMA has become a vocal advocate of improving competition in global financial markets. It has come out strongly in support of the SEC's mutual recognition efforts. In fact, SIFMA has warned that the CSA's plans to reform the registration system in Canada could disrupt markets by chan-

ging rules that have to be altered again when mutual recognition is finally achieved.

Nevertheless, although SIFMA favours moving toward mutual recognition, it has also called for the reform of the foreign broker rule as an immediate step in that direction, saying that it would improve efficiency, increase investment opportunities for U.S. investors and improve competitiveness.

The proposed changes, Russell says, could be "the silver lining" amid the pessimism that otherwise hangs over the industry's mutual recognition aspirations.

Mutual recognition may remain the ideal, but reforming the foreign broker rule could deliver many of the same benefits to the institutional market right away. **IE**

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