BY JOEL KRANC

Regulatory Cooperation That Overlaps Borders

It has been called the world's longest undefended border and yet Canada and the United States are once again making efforts to combat a certain type of aggressor. Though the threats do not come from armies or terrorists, there is an effort afoot to guard against securities fraud and market malfeasance that has plagued both countries in the recent past.

Earlier this spring, the U.S. Securities and Exchange Commission (SEC) announced that it, along with the Ontario Securities Commission (OSC), would begin a process to "… discuss ways to further strengthen cooperation regarding their supervision of financial firms …" In addition, the two agencies discussed their respective approaches to examinations, investor education initiatives and the status of regulatory reforms in each jurisdiction.

The SEC and OSC staffs also discussed "additional coordination in the oversight of dually regulated entities," and they agreed "to meet regularly to discuss issues of mutual significance regarding supervisory coordination and emerging risks in the cross-border market."

The timing of the announcement and the discussions leading up to it represent something of a shift in thinking about the ways in which cross-border securities monitoring occurs. In the pre-financial crisis era prior to 2008, the SEC worked with counterparts in other countries and jurisdictions — in this case the OSC — mostly on a case-by-case basis. If law was broken, cross-border investigations took place; but the two regulators only dealt with each issue as it arose.

In fact, the SEC and OSC have had Memorandums of Understanding (MoU) long before the financial crisis hit.

"A number of years ago the SEC and its counterparts developed protocols for cooperation in enforcement matters," says Ethiopis Tafara, director of the SEC's Office of International Affairs.

"Starting in the early 1990s we realized that with national boundaries and global markets the only way you survive as a regulator is through collaboration and cooperation with your counterparts around the world," he says.

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As a result, the SEC and counterparts developed and entered into MoUs and other cooperation arrangements that have resulted in more than 40 bilateral relationships with other regulators.

Cooperation under these arrangements is triggered by a potential violation of the law, notes Tafara, but "it also makes sense to cooperate long before the law is broken and to assist one another in the supervision of global actors that have a footprint that spreads across borders."

MoUs are just a framework for discussion, he adds. "Having conversations about what you are seeing in your marketplace with respect to a [global] market or a registrant is what is most important. And to the extent that the registrant has a footprint that spreads into another jurisdiction you need to have conversations with those people as well."

Kelley McKinnon, a former deputy director of Enforcement and chief litigation counsel at the OSC, says there have been MoUs specifically between Canada and the U.S. and there have also been multi-lateral agreements with other countries. And while MoUs are not new nor do they necessarily cover new ground, they do, at least in this case, offer insight into a somewhat changed mentality.

What's new this time, says McKinnon, "is that this is more self-assessment in the aftermath of the financial crisis where they said 'what steps can regulators take to better regulate based on what we've learned from the financial crisis?' Both countries decided to look at cross-listed companies that were important players with significant financial influence."

Tafara notes that cooperation already existed between the U.S. and Canada. However this new agreement provides a little more formality. If an issue arises, each regulator now knows what to expect in terms of use and disclosure of non-public information by virtue of the process and routine set forth in the agreement.

Now, he adds, "we are looking at a more proactive as opposed to reactive engagement and a more comprehensive rather than ad-hoc [process]." This, he stresses, allows the two regulators to anticipate and move toward an issue, rather than waiting for it to happen.

Carlo di Florio, director of the SEC's Office of Compliance Inspections and Examinations, says that in the past there might have been more concentration on

firms or issues whereas now there is more of a risk dialogue by looking at industries and sectors or products — not just companies. The goal is to think and talk about strategies before they become a problem.

"It looks as if they are getting much more serious about getting standardized protocols in place and probably formalizing some of the things that they've done previously," says McKinnon.

She adds that "part of what regulators are trying to do is be more efficient in the use of their resources. Historically, if you have investigations going on in silos, a regulator might be missing opportunities to cooperate that would make better use of resources."

It is the silos that are exactly at the heart of these initiatives. Expanding investigations beyond a department or geographic border would prevent crises of the magnitude seen in the financial meltdown of a few years back — or at least so the logic goes.

New Players, Changing Market

The evolution of the financial crisis and general oversight needed in the market prompted regulators to establish not only relationships with counterparts but within their own walls.

The SEC's di Florio says, "We've undertaken a significant restructuring of our program to leverage the lessons learned through the financial crisis to make sure we are adapting and enhancing our program moving forward. Part of that was to break down silos within the SEC and with other regulators.

Having already established good outreach on the home front, [we are] now turning to strengthening relationships and risk dialogue with regulatory partners around the world."

He adds that the SEC wants to make sure it is effectively coordinating and collaborating with the OSC — whether it's broker-dealers operating in both Canada and the U.S. or hedge funds, private equity firms or investment companies that may be operating across jurisdictions or clearing agencies or transfer agents.

By entering into such agreements and having regular contact, one can better address obstacles that may exist to cooperation, says Ermanno Pascutto, executive director of the Canadian Foundation for Advancement of Investor Rights and former executive director and head of staff at the OSC.

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In addition, he adds, it helps establish relationships between the key people in the different organizations. "Both those things are vital in times of crisis. If you've never met the counterparties that you have to deal with when a crisis starts, then you've got a problem," Pascutto says. It's a lot easier, he says, "to cooperate when you have arrangements in place and a relationship between the two organizations to deal with the particular area — in this case supervision of market intermediaries."

The financial crisis prompted them to review the entire regulatory system — "looking at things like credit rating agencies for the first time and an agreement on cross-border cooperation in supervision of financial intermediaries," adds Pascutto.

Although the moves at better cooperation began prior to the crisis, the collapse of the banking system certainly helped speed things along. The SEC's Tafara says it has been an evolutionary process over the years, "but I will say the crisis has acted as an accelerant and has moved us down the path maybe faster than it would have otherwise."

Future Crises?

Since the 2008 crisis, there has also been a need to address new registrants and global actors within the world's financial system. There have been a dearth of new registrants including hedge funds, says di Florio, as well as private equity funds, municipal advisers and five new categories of SWAP registrants. These registrants have become a new responsibility and a top priority.

There are also new and emerging risk trends, as well as perennial issues to monitor and coordinate. On the broker-dealer side, there are new trading limits, platform and product risks, as well as perennial monitoring of funding, liquidity, net capital and customer protection rules.

On the investment management side, there are new and more sophisticated private fund business models to examine and the need to focus on conflicts of interest, insider trading and market manipulation, among other things.

The preventative nature of the newer arrangements will help regulators in future crises. Pascutto says that only by having these arrangements in place and by establishing relationships can risk be changed and monitored in an optimal manner.

If governments and the regulatory bodies that work to protect markets, shareholders and consumers learned anything from the financial crisis, it is that systemic risk can be much more dangerous and influential than, for example, smaller issues such as insider trading.

McKinnon says that reading between the lines, with the extent of cross-border activity, regulators need to have cross-border oversight on their "to-do" list when there is the possibility of systemic risks.

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