

Commentary: The Global Reach of U.S. Financial Services Regulation

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The Obama Administration's proposal for financial services regulatory reform leaves global issues to the end – the last nine pages of an 85-page report. This is an interesting choice. Almost everything the Administration proposes in the first 76 pages can be undone by the actions of global regulators abroad.

The cornerstone of the Administration's proposal is the empowerment of the Federal Reserve as a regulator of systemically significant institutions, called Tier 1 Financial Holding Companies (Tier 1 FHCs).

But, let's suppose that one of these Tier 1 FHCs happens to be a foreign corporation operating in a European country. The Administration proposes that the Fed might apply its rules to this foreign Tier 1 FHC.

To imagine what this might look like, let's suppose that the Fed designates Societe Generale, a French banking firm with extensive US operations, as a Tier 1 FHC. The Fed would be entitled to examine the books and records of Societe Generale's operations in France. Going further yet, the proposal suggests the Fed could even apply its rules to the world-wide operations of the foreign firm. This presents the curious spectacle of the Fed attempting to regulate, in a fairly intrusive way, the Chinese operations of Societe Generale.

Installing the Fed as a regulator of more US financial institutions is one thing. Making it the global regulator of systemically relevant institutions is beyond the power of the United States.

Global markets regulation is inextricably linked with affairs of State. To say the least, the United States has from time to time disagreed with the government of France with respect to international issues. Until recently, France enjoyed a much better relationship with Iran than the United States. Even now, a decent amount of trade passes between France and Iran, and various banking relationships facilitate this commerce. US businesses are, with limited exceptions, forbidden to trade with Iran. It is not hard to imagine France objecting to a US regulator demanding information that, among other things, details Societe Generale's banking relationships with Iran. My guess is that France would object to the Fed obtaining any non-public information about Societe Generale's operations outside the United States.

To avoid these international conflicts, the Fed could decide to apply its regulations only to Societe Generale's US operations, or those operations that affect the US financial markets. The "mutual recognition" concept developed by the Securities and Exchange Commission during the tenure of Chairman Cox is an example of how this strategy might work. The idea is that we would not impose US securities regulations on operations supervised by non-US securities regulators, but would recognize the right of every country to regulate capital markets in their own way. To avoid duplication of effort by institutions regulated by more than one jurisdiction, we attempted to harmonize some standards. For example, the SEC agreed that IFRS was an acceptable accounting standard, rather than requiring foreign issuers to adopt US GAAP.

The Obama Administration appears to have rejected mutual recognition as an acceptable theory of global financial services regulation. The SEC apparently intends to revisit its IFRS decisions. In any event, mutual recognition would run counter to some other principles the Fed is supposed to consider.

The Administration's proposal states that the Fed should "give due regard to the principle of national treatment and equality of competitive opportunity between foreign-based firms operating in the United States and US-based firms." However, the Fed will be applying its regulations to the foreign operations of US firms. If the Fed determines, for reasons of diplomacy or otherwise, to limit its regulation of Societe Generale to its US operations, that will be inconsistent with the principle of "equality of competitive opportunity."

It is important to consider what systemic regulation is all about. Essentially, the Fed will be limiting or prohibiting financial services firms from engaging in profitable businesses. If the Fed determines that there are too many derivatives floating around, the Fed will require Tier 1 FHCs to limit their sales of these instruments, even though there are customers desperate to buy them. This also means that if the Fed restricts sales by US firms, institutions with accounts at Societe Generale will simply buy them in France -- unless the Fed can also require Societe Generale not to sell them. On the other hand, if the Fed cannot prohibit sales by Societe Generale in France, US firms will complain to high heaven that they are being unjustly deprived of a competitive opportunity.

One solution to this conundrum was played out in dramatic fashion last week. We can simply prohibit any foreign firm that will not cooperate from doing business in the United States.

The Florida office of UBS offered wealthy US customers some interesting products that involved opening bank accounts in Switzerland. The Internal Revenue Service charged that these products constituted criminal tax evasion and obtained a

settlement with UBS in February. The Swiss are famous for their bank secrecy laws, but have maintained loudly to all and sundry that these laws cannot be used for tax evasion, money laundering or other criminal activities. So, in the settled criminal case, UBS was required to provide information about 250 related Swiss bank accounts, which did not violate Swiss banking laws.

On the theory that where there's smoke, there's fire, the IRS then demanded, and sought an order from a Federal court, that UBS relinquish information about another 52,000 Swiss bank accounts of US persons, which the IRS had reason to believe were also used for criminal tax evasion. On the grounds that the IRS is conducting a "fishing expedition," the Swiss argued that their bank secrecy laws prohibited this sort of disclosure. Accordingly, the Swiss government responded by threatening to seize all information related to these accounts to prevent UBS from delivering it to the IRS. The Federal court countered by ordering US prosecutors to explain whether the United States would consider seizing the US assets of UBS or forcing it into receivership, which would involve shutting down its operations. It is not clear that UBS, a systemically relevant financial institution with global operations, would survive a seizure of this magnitude.

At the time of this writing, negotiations are ongoing with the Swiss government. The court has issued a two-week stay to allow these negotiations to proceed.

International brinksmanship is not a desirable way to accomplish systemic regulation. The alternative, however, is to recognize that global systemic regulation is necessarily a matter of international diplomacy. The Fed will need to reach agreements with its foreign counterparts to share information and impose equivalent regulatory restrictions and prohibitions.

The G-20 summit in April proposed the institution of a college of regulators that would meet from time to time to discuss issues of concern. My guess is that this sort of discussion will have to be held at many levels and be ongoing if systemic regulation is to have a single tooth in its head.

There are institutions where commercial interests are represented on a global level. The World Trade Organization is an example of this sort of ongoing diplomatic effort to find common ground in economic matters by reducing barriers to trade. For some time now, economists have been in agreement that most trade barriers are self-destructive, which offers many opportunities for trade agreements that are mutually beneficial to all concerned. However, the history of international economic cooperation, even where there is widespread agreement as to the benefits to be achieved, has been spotty at best.

The Administration's proposal for global systemic regulation by the Fed is much more aggressive than anything that has ever been accomplished by anything short

of imperial conquest. But, in the absence of a global solution, the most important part of the proposal is doomed to fail.

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