

The Yin and Yang of Global Securities Regulation: The SEC Signs the First Mutual Recognition Arrangement with the Australian Securities and Investment Commission

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On August 25, 2008, SEC Chairman Christopher Cox, Australian Securities and Investment Commission (ASIC) Chairman Tony D'Aloisio, and Australian Senator Nick Sherry announced that they had entered into a mutual recognition arrangement. While this is the first of its kind, the SEC hopes to enter into mutual recognition agreements with a number of non-US regulators.

The stated purpose of mutual recognition is to allow Australian stock exchanges and broker-dealers to provide execution and brokerage services to US investors without registration under the Securities Exchange Act of 1934 and to allow US stock exchanges and broker-dealers to provide similar services to Australian investors without receiving the authorization of the ASIC. The agreement does not spell out exactly how this would be accomplished. Instead, each side has agreed not to discriminate against each other's financial institutions. Further regulation will be required to implement this agreement.

Under the agreement, Australian stock exchanges and broker-dealers would be permitted to sell their services to most US Qualified Investors, a term defined in the Exchange Act. It includes investment companies (mutual and closed-end funds), hedge funds that only accept investments from qualified investors (3(c)(7) Funds), banks, broker-dealers, insurance companies, business development companies, state pension plans and most corporate pension plans, funds or high-net worth individuals with more than \$25,000,000 in investments. As readers of this column, or SEC watchers know, the SEC has proposed to broaden this definition for any foreign broker-dealer that is supervised by a recognized foreign monetary authority, which would moot the Australian mutual recognition arrangement. But, the agreement provides that, if that should happen, the SEC will further broaden the category of US investors with whom an Australian broker-dealer could do business. About all that's left in the way of US investors to include, at that point, is retail.

For its part, the ASIC is prepared, in general, to permit US exchanges and broker-dealers to do business with all of their investors that are not retail, as defined in Australian corporate and securities law.

In any event, the Australians would only be permitted to offer Australian securities to US investors, and US broker-dealers would only be permitted to offer US securities to Australian investors. Proposed amendments to Rule 15a-6 presumably would also expand the securities that Australian broker-dealers could offer to qualified investors to include US securities. While the devil, as always, remains in the details, nothing in the mutual recognition agreement would require an Australian broker-dealer to use a US clearing firm to hold accounts for US person. It remains to be seen whether or not the regulations that develop around this agreement will require the involvement of a US clearing firm, as is the case with proposed Rule 15a-6.

This first step into the fantasy world of globalization is fraught with implication. Without knowing anything much about Australian securities regulation, one has to assume it is different than US regulation. If it is also less costly, Australians will be able to offer financial services at lower cost than US broker-dealers. This also means that the comparative cost of raising capital will be relatively more expensive for one jurisdiction. These cost differentials are likely to cause some unintended consequences. For example, US issuers that have subsidiaries in Australia might find it more efficient to cause those subsidiaries to offer securities to US investors, rather than offering securities through the parent. One can imagine US issuers setting up Australian finance subsidiaries for no purpose other than to raise capital more cheaply.

Cost differences will also cause US broker-dealers to set up Australian affiliates. Investment banks know how to follow the money. Smaller broker-dealers will see their product diminished. Where it doesn't make sense to establish an Australian office, smaller broker-dealers may well be priced out of the market.

The fact is that it doesn't take a lot of art of issue Australian securities, rather than US securities, if there is something to be gained by doing so. I expect that investment professionals will be looking for ways to exploit these new finance opportunities. If the SEC establishes a lot of these mutual recognition arrangements, the opportunities to exploit cost differentials will multiply.

Finally, it is hard to imagine that retail investors will take kindly to being left out of all this amusement. While competition will cause more stress on the financial services industry, it is undoubtedly good for consumers of financial services. They will have access to more financial products at more competitive prices.

The downside is that there will be more risk that investors will be defrauded. It can be expected that at least some of the countries with whom the SEC will enter into mutual recognition arrangements will not protect investors with the famed robustness of US securities laws. Moreover, the ways in which investors are protected in other jurisdiction are, at a minimum, different. In many jurisdictions,

certain investors (retail) are protected by simply not being permitted access to certain products. In the US, this sort of paternalistic administration is an anathema. The most recent proposal by the SEC to raise the financial bar for investment in hedge funds was met by hundreds of angry comments from investors who would be protected by not being permitted to invest in these instruments. Paternalistic and other regulatory schemes that work well in a particular foreign jurisdiction may not translate well into the American culture.

The SEC at least pays lip service to this problem in the Australian agreement. Both sides have agreed that they are not relinquishing their right to prosecute fraudulent conduct and have agreed to assist each other in their enforcement efforts.

While that sounds good, the fact is that the US doesn't have the same definition of fraud that exists elsewhere. In 2007, the British authorities shocked the London investment community by bringing its first criminal action for insider trading, something they have been threatening to do, with the SEC's encouragement, for some time. The US Department of Justice has been locking people up for insider trading for decades.

It is therefore unclear how mutual recognition, and joint enforcement agreements, will work in practice. It is easy to picture the SEC resisting the enforcement of a fraud action by a foreign authority against a US citizen when the same conduct would not be enforceable in the United States. The recent silliness involving the use by the Supreme Court of foreign legal authorities suggests that the US Congress is likely to interfere in such legal actions. Similarly, a hue and cry went up in London when British authorities recently agreed to extradite three British investment bankers involved in the Enron scandal. The opposition raised the matter in Parliament, charging the ruling Labor party with violating the rights of British citizens.

All that said, it is clear to me that the world has changed and, like it or not, globalization in the form of mutual recognition is a train leaving the station. The Australian mutual recognition arrangement may be the first of its kind. It won't be the last.

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