INTERNATIONAL LAW ASSOCIATION

BRITISH BRANCH

INTERNATIONAL SECURITIES REGULATION: EXTRA-TERRITORIAL ASPECTS

THE ENGLISH LAW PERSPECTIVE

COMMITTEE:

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1. INTRODUCTION

1.1 Membership

This is a first report by a Committee of the British Branch of the International Law Association, formed to work in parallel with the ILA International Committee on Securities Regulation (Harmonisation and Extra-Territorial Effects). The Branch Committee was formed soon after the constitution of the International Committee following the Warsaw Conference of the ILA, held in August 1988.

Members of the Branch Committee are:

Nigel Fox Bassett, Clifford Chance, London, Chairman.
Jane Welch, The Securities and Investments Board, London.
Roger McCormick, Freshfields, Paris.
Peter Willis, Mallesons Stephen Jaques, London, editor.

Messrs Fox Bassett and Willis are also members of the International Committee, nominated by the British and Australian branches respectively.

The Committee has met 6 times at the offices of Clifford Chance and expresses its appreciation of the facilities provided. Philip Osborne of Clifford Chance served as secretary to the Committee. The Committee also records its gratitude to Mallesons Stephen Jaques for the printing and distribution of this report.

This report includes contributions from each member of the Committee and represents the individual views of the members in their personal capacity.

1.2 Purpose

The Chairman and Rapporteur of the International Committee invited each Branch committee to "consider including in its work a report ... on those aspects of the national legislation and regulation of financial services and securities markets that have extraterritorial effect".

This report represents the response of the British Branch Committee to this invitation.

The Branch Committee understands the purpose of this enquiry to be to lay the ground work for a proper understanding of the international legal and regulatory issues arising in international securities transactions and of the processes involved or likely to be involved in working towards harmonisation of national laws in the field.

More particularly, the purpose of identifying extra-territorial effects may lead us to consider.

(1) whether this gives rise to practical disadvantages in international securities markets;

(2) whether the extra-territorial effects are justifiable; and

(3) whether the extra-territorial effects, even if justifiable, are an attempt to achieve an object which could be more conveniently achieved in another manner, for example by treaty or by mutual reshaping of laws.

The Committee has not attempted to define exhaustively the field of activity encompassed by "Securities Regulations". We have excluded commercial banking and insurance matters. We have included all kinds of instruments as securities: shares, debt, hybrids of these, commodities and futures, and options and warrants for the issue or purchase of any of these In addition, there are requirements governing the licensing and behaviour of participants in the relevant market. The field could also include the securities and financial market aspects of take-over offers and mergers.

We have tended to concentrate on legislation relating to the conduct of business and particular facets of business rather than on specific kinds of transactions.

Because the United Kingdom is a member of the European Community, the system of law encompassed by "national legislation" of the UK includes existing and proposed requirements incorporated in or affecting domestic law through the processes of the European Community. We refer to this appropriately. We are also aware that this has been the subject of particular study by the International Committee arising from the path breaking work which the European Community is undertaking. Any overlap between the Branch Committee report and that of the International Committee does not require apology: the issues are extremely important and the national perspective gives rise to different emphasises from the consideration by the National Committee.

1.3 As far as the application of United Kingdom law is concerned, the obvious point is made by Dicey & Morris: "The Parliament of the United Kingdom does not legislate for the whole world". However, although there may be a presumption that "Parliament does not design its statutes to operate beyond the territorial limits of the United Kingdom", this is easily rebuttable. (Examples include the application of the Theft Act 1968 to a theft of crayfish committed by Western Australian fishermen twenty miles off the coast of Western Australia). To what extent does English securities legislation have extra-territorial ambitions?

Although the **Financial Services Act 1986** is not the only legislation concerned with the regulation of securities businesses, it is central to the "self-regulatory" system adopted in the UK for securities business and therefore investment banking and is the legislation with which those concerned with EC harmonisation and mutual recognition will have to come to terms. However, the Act is not "self-contained" but only provides the framework for the establishment of "recognised self-regulating organisations" ("**SROs**") which in turn establish a myriad of rules and regulations for different sectors of the securities industry.

This report is therefore primarily concerned with the potential extra-territorial scope of the Financial Services Act and the rules and regulations of the self regulating organisations made pursuant to the Act and the manner in which, notwithstanding the "self-limiting" nature of the legislation, the perceived needs of effective "domestic" regulation may, arguably, be considered to give rise to certain "extra-territorial" effects, particularly when applied to a mutual recognition system such as that envisaged for the European Community.

2. EXTRA-TERRITORIALITY - BASIC PROPOSITIONS

2.1 **There are obviously degrees of "extra-territoriality", some of which may be acceptable and some of which are not.** Civil and criminal offences may provoke different responses.

The point may be demonstrated by analysing a series of simplified fact situations. Should the UK, for example, attempt to regulate the following:

(a) A in the UK issues a fraudulent prospectus to B in the UK

(b) A in the UK issues a fraudulent prospectus to B in France

(c) A, a French national in France, issues a fraudulent prospectus to B in the UK

(d) A, a British national in France, issues a fraudulent prospectus to B in France

(e) A in France issues a fraudulent prospectus in France to B in France.

In the case of (a) obviously yes. Here there is no element of extra-territorial jurisdiction.

(b) raises the question of states allowing their territory to be used for boiler room operations aimed at other states and not at the nationals of the host state. Not every legislature chooses to exercise jurisdiction in such a case (for example, if the fraud relates to foreign securities).

(c) is the obverse of (b). The posited case provides a substantial direct connection with the territory of the legislature - for example, receipt of a fraudulent document in the UK. However when the connection with the legislating territory is more indirect one approaches the "effects doctrine" - again controversial.

In the UK, this is regarded as properly within the scope of domestic regulation. Nevertheless, it is interesting to note that in previous years, UK legislation offered a more relaxed approach to overseas issuers than to local issuers. (Indeed, this formed the original basis for Eurobond markets.)

(d) and (e) on their own are rarely exercised. In the case of (d), the nationality principle would provide a theoretically acceptable basis for jurisdiction (especially criminal). However, in practice, it is likely to give rise to serious complications and overlap. On the face of case (e), without further facts, such as effects or corporate links (in either case, debatable), there is no nexus at all.

The Financial Services Act adopts both the (b) and (c) approach in places - see 3.5 below - and picks up elements of (d) in the case where the subsequent sale of securities takes place in the UK. In terms of this example such approaches obviously create the potential for conflict with the French rules.

2.2 **Legislation which purports to have an "extra-territorial" effect potentially offends the sovereignty of other states.**

Few states welcome outside interference by foreign states seeking to exercise a "long arm" policy of control over matters judged to be sufficiently important to justify "extra-territoriality" (eg, anti-competitive trade agreements and "asset freezing" orders against nationals of hostile countries). Section 1(1) of the Protection of Trading Interests Act 1980 (UK) gives a good example of the policy in the UK when it states that:

> "If it appears to the Secretary of State
>
> (a) that measures have been or are proposed to be taken by or under the law of any overseas country for regulating or controlling international trade; and
>
> (b) that those measures insofar as they apply or would apply to things done or to be done outside the territorial jurisdiction of that country by persons carrying on business in the United Kingdom, are damaging or threaten to damage the trading interests of the United Kingdom,
>
> the Secretary of State may be order ..." effectively prohibit compliance with any such requirement or prohibition by any "person in the United Kingdom".

The Act contains similar provisions relating to documents and information required by overseas courts and authorities which are judged to "infringe jurisdiction of the United Kingdom" or otherwise be "prejudicial to the sovereignty of the United Kingdom".

The policy behind such legislation is fully reflected in English court decisions, particularly the line of cases related to the impact of "foreign illegality" on contracts governed by English law where the contracts require no act to be performed in the foreign jurisdiction.

2.3 **The nature of international securities business and the need for its regulation can make "territorial jurisdiction" seem an outmoded concept.** Securities businesses need to be regulated for many different reasons Investor protection may be regarded as the primary, although not necessarily an absolute, objective. We note the identification by the ILA International Committee of a second, overlapping objective: protection of the soundness of national and international economies and financial systems. We agree with this analysis.

In summary, most sophisticated legal systems recognise the need to:

(a) have some form of licensing system for those businesses concerned with the marketing of investments,

(b) regulate the documentation (eg, prospectuses) used for the promotion of investments;

(c) control "insider" dealing and securities-related fraud.

While the objectives and areas in need of regulation may be agreed, nations have adopted quite different strategies in regulation, as well as setting different standards. This is understandable and reflects decisions of policy, influences and heritage in areas well beyond differences in the nature or structure of local securities markets.

Until relatively recently, securities markets were primarily of local interest and significance. This has changed in the last decade or more, leading to a belated recognition of the limitations of traditional, territorially-confined laws.

From the point of view of market participants, differences of approach (or, worse, incompatibility) of national laws add to the cost, time and complexity of transactions.

From the point of view of regulators, traditional territorial approaches only capture part of a transaction which is otherwise a whole and may render attempted, unilateral enforcement ineffective.

In the new era of "global" markets the need to regulate the securities industry has to be balanced by the desire of certain cities or states to be considered an attractive "centre" for securities markets. Thus, Paris seeks to "compete" with London as the "European" centre and it is thought that in the future Frankfurt might similarly compete. Meanwhile London "competes" with New York and Tokyo. This degree of regulation in each centre (in conjunction with other things, such as tax laws and economic factors) affects the overall ability of that centre to "compete" with other centres for market location. Thus any perceived "over-regulation" in the UK is immediately criticised as being likely to "drive the Euromarkets away from London". On the other hand, a system which is not adequately regulated by itself or by the State will not command investor confidence and is unlikely to develop.

Whatever regulatory system is established, it is difficult to make it work effectively without taking account of the manner in which international transactions are effected. Thus, it can be difficult to police regulations restricting insider dealing if the "insiders" make use of "secrecy" jurisdictions to cloak their activities. Similarly, laws requiring disclosure, for example, of ultimate beneficial interests in shares (as found in s.212 of the Companies Act 1985) would be of no avail if they could be defeated by "secrecy" laws of another jurisdiction which prohibited such disclosure. In a civil matter, the UK courts can take action "within" the UK, by freezing the rights attached to shares until the foreign beneficial ownership is fully disclosed. This may force a shy investor, relying on foreign secrecy laws, to instruct any intermediary bank or dealer to disclose the owner's identity.

2.4 **"Territorially-confined" requirements of strong markets may nonetheless have extra-territorial consequences** The effects of disclosure orders under the Companies Act is one example of this (and similar orders and effects arise under the laws of other countries). In reverse, UK futures and commodities dealers wishing to trade in US instruments or markets must modify their UK practices as a result of US "domestic" requirements, for example, concerning segregation of client moneys.

While those who are forced to alter their "home" behaviour in order to participate in a foreign market may complain at the intrusion on their affairs and label the impact of the market's requirements as "extra-territorial", it is at first sight difficult to see how a host country can prevent its rules and requirements impinging on foreign participants acting within its territory. Provided the requirements imposed on foreign participants are not discriminatory, there may be little reason for objection, on the grounds of "extra-territoriality" or otherwise. The foreign participant is essentially reacting to the "differentness" of the regime and may ask why its "home" practices and rules are not adequate; on the other hand, the local participants will expect foreign participants to be treated no more favourably. Rather, the real issue is how best to reconcile any duplicated or conflicting rules or requirements of the overlapping jurisdictions which necessarily arise when a foreigner participates in another country's market.

2 5 **"Level playing fields" require some sacrifice of sovereignty.** It is generally accepted that fully effective regulation will require international co-operation. As between advanced economies, there is a great deal of emphasis on reducing protectionism or structural rigidity, to permit equal access to markets and fair competition in them without reference to national origin. There has already been much talk of the desired "level playing field" as between the UK and the USA in relation to banking activities. This has resulted in a unified approach to the question of the measurement of the capital adequacy of banks, put forward by the Bank for International Settlements in Basle. Common approaches and the principle of mutual recognition of regulatory requirements are now beginning to find favour within the EC in the securities area. The Financial Services Act already anticipates a mutual recognition system in Section 31 - see 3.4 below.

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The remainder of this report is concerned with the approach to mutual recognition found in the Financial Services Act and elsewhere in UK practice, how the principles underlying the Act can be reconciled with the relevant EC directives and what implications this has for "extra-territoriality".

3. THE TERRITORIAL SCOPE OF THE FSA

3 1 The principal English statute on the **regulation** of the securities industry is the Financial Services Act 1986. This would probably be classified by Dicey & Morris as "self-limiting" - as it is concerned with the regulation of persons carrying on "investment business in the United Kingdom".

Persons regulated - "in the United Kingdom"

Only authorised or exempted persons are permitted to carry on such business and much of Part I of the Act is concerned with how authorised or exempted status is to be obtained. As regards regulation generally, the important preliminary question (which immediately raises the question of "extra-territoriality") is what is meant by carrying on investment business **in the United Kingdom.** This is addressed by Section 1(3) which provides

"For the purposes of this Act a person carries on investment business in the United Kingdom if he -

(a) carries on investment business from a permanent place of business maintained by him in the United Kingdom; or

(b) engages in the United Kingdom in one or more of the activities [described in Schedule 1 to the Act which (broadly) defines "investment business"] and his doing so constitutes the carrying on by him of a business in the United Kingdom."

The Financial Services Act has given rise to many difficulties in interpretation and Section 1(3) is no exception. Further points of interpretation relevant to the "extra-territorial question" are considered in 3.2 below. However, it is clear that the relevant jurisdiction is by its terms restricted as to its geographical application. Limitation to "territorial jurisdiction" is broadly accepted as a matter of principle.

3.2 Clearly, the first test in section 1(3)(a) is the easier to apply since it will generally (but not always) be reasonably easy to ascertain whether or not a person has a "permanent place of business" in the UK. The second test comes close to a circular definition since it begs the question as to what exactly does "constitute the carrying on" of a business in the United Kingdom. Clearly, the legislation is intended to catch persons who have a sufficient degree of activity within the UK to be regarded as carrying on business there even if they do not have a permanent place of business. Whilst the concept may be difficult to apply in certain circumstances, it would perhaps be unduly harsh to regard the draftsman as guilty of "extra-territoriality".

3.3 **Foreign unauthorised principal - authorised UK agent**

Section 1(3) of the Financial Services Act has to be read with Schedule 1 Part IV to the Act. This reduces the potential scope of the second test in section 1(3)(b) since a person who otherwise might be caught by the second test (ie, a person who does not have a permanent place of business in the UK) will not be brought within the regulatory system to the extent that the transactions he concludes are made with or through other persons who are themselves authorised or exempted under the Act.

There are similar exemptions for "arranging" investment deals to the extent (broadly) the arrangements or transactions are by or with authorised or exempted persons. There are also certain exemptions for transactions which are either initiated from the United Kingdom or solicited by an overseas person in accordance with the cold calling to advertising rules. The drafting of the legislation is, it has to be said, extremely complex (reflecting a large number of theoretical situations involving "foreigners" and "nationals") and, in turn, has to be read with the relevant provisions of the rules of the SROs.

3.4 **Recognition of other regulatory regimes**

The principle of "home country control" expected to be established by an EC Directive (see below) is anticipated by Section 31 of the Financial Services Act This confers authorisation for the purposes of the Act on persons who are "established in a member State other than the United Kingdom" provided that·

(i) the law of that state recognises him as a national of that or another member State; and

(ii) he is for the time being authorised under that law to carry on investment business or invest business of any particular kind.

A person is "established in a member State other than the United Kingdom" if

(i) his head office is situated in that state and

(ii) "he does not transact investment business from a permanent place of business maintained by him in the United Kingdom".

As far as the Act is concerned, therefore, the establishment of a permanent place of business in the United Kingdom would take an investment business out of the potential scope of automatic authorisation under section 31.

Section 31(3) foreshadows the difficult negotiations which are likely to be necessary to achieve full mutual recognition. This states that the section only applies if the provisions of the foreign law "afford to investors in the United Kingdom protection, in relation to his carrying on of that business, which is at least equivalent to that provided for them by the [authorisation] provisions of [the Financial Services Act]" or "satisfy the conditions laid down by a Community instrument for the co-ordination or approximation of the laws, regulations or administrative provisions of member States relating to the carrying on of investment business or investment business of the relevant kind". There is provision for the Secretary of State to issue a certificate which would be conclusive evidence of the satisfaction of this test (although the absence of a certificate would not be conclusive the other way). In order to fall within the second part of the test (which refers to the "Community instrument") the investment business would have to obtain a certificate from its "home" country stating that it is authorised to carry on the relevant business "under a law which complies with the requirement of that paragraph".

3.5 Particular activities

Those parts of the Act which are concerned more with "conduct of business" and specific marketing activities also tend to limit their scope to the United Kingdom - although in different ways.

A good example of this is section 47 which is concerned with misleading statements and practices. Subsection (1) makes it an offence to make statements, promises or forecasts which are known to be misleading, false or deceptive (and also to dishonestly conceal material facts); the reckless making of such statement, promises, forecast, etc is also caught The provision only applies if the activity is made to induce another person to enter into or refrain from entering into an investment transaction. However, it is specifically stated (in subsection (4)) that the provision does **not** apply unless one of the following "territorial" tests are satisfied·

(a) the statement, promise or forecast is made in or from, or the facts are concealed in or from, the United Kingdom;

(b) the person on whom the inducement is intended to or may have effect is in the United Kingdom; or

(c) the investment transaction would be entered into or the investment rights affected would be exercised in the United Kingdom.

Section 47(2) is concerned with misleading the market. Again, a "territorial" test is laid down by subsection (5) which says that the offence is not committed unless

(a) the act is done or the course of conduct is engaged in the United Kingdom;

(b) the false or misleading impression is created there.

Other examples of "territorial limits" can be found in section 56(1) - which is concerned with unsolicited calls ("cold calling") and section 57(1) - which is the basic provision restricting the circulation of "investment advertisements" (eg, prospectuses and similar documents - the definition is extremely wide).

Section 56 fixes upon any connection with the UK. It applies to calls made from anywhere on persons in the UK and to calls made from the UK to persons anywhere. Section 57 applies to the issue of an investment advertisement "in the United Kingdom". It is considered that this applies to any situation when an investment advertisement is circulated or shown within the territorial limits of the United Kingdom even if it is, for example, posted from outside the United Kingdom. Generally, it is not thought that the section applies to investment advertisements which are merely posted from the United Kingdom and are not otherwise circulated or shown there.

Accordingly, the issue of an investment advertisement by A in France to B in the UK will be caught by section 57. However, the issue of an investment advertisement by A in the UK to B in France will not be caught by section 57 but a UK broker who advises clients in France from a permanent place of business in the UK is apparently caught by section 1(3)(a) of the Act. Similarly section 1(3)(b) will catch A a broker in France, who advises B the client in the UK (subject to exclusions).

3.6 SRO Rules

The limits on the type of investment business which an SRO member can carry on by virtue of such membership are defined in the respective "Scope" Rules contained in the SRO Rulebooks. All the SRO Rulebooks prohibit a firm from carrying on investment business of a kind with which they are not concerned unless the firm is an exempted person in respect of that investment business or otherwise authorised under the Financial Services Act.

Although, the "Scope" Rules give a good indication, it is generally unclear as to the extent to which a firm's investment business will be regulated once SRO authorisation is obtained. It is possible to argue that the contractual relationship between the SRO and its members enables the SRO to impose obligations even on the firm's investment business carried on overseas. However, as a matter of fact, not all the SRO Rulebooks attempt to address this matter. By way of example, The Securities Association

(covering stockbrokers and dealers) to a degree limits the application of its Rules, by exempting foreign business which, if carried on or undertaken from an office outside the UK, would mean that firm would not be carrying on investment business in the UK and so not require authorisation.

3.7 City Code on Takeovers/Stock Exchange Listing Rules

There is no direct statutory regulation of the security aspects of takeovers in the United Kingdom. Such regulation as exists depends on a consensus among regulatory authorities responsible for security markets and participants, the SROs and market participants. This consensus is embodied in the **City Code on Takeovers and Mergers** ("City Code"). The City Code deals with all aspects of agreed and hostile takeover offers and mergers and contains specific rules concerning disclosure of substantial shareholdings in companies. These rules are in addition to provisions in the Companies Act on the same subject.

The application of the City Code depends on the status of the offeree or target. It applies to offers for all public companies and other corporations, listed and unlisted, considered by the Takeover Panel, the administering authority, to be resident in the United Kingdom, associated jurisdictions or the Republic of Ireland, by special arrangement consequent on the unique bilateral nature of the International Stock Exchange in London and Dublin. The Panel will normally consider a company to be so resident only if it is incorporated in and has its head office and place of central management in one of those jurisdictions.

Consequently, takeovers and related securities transactions of non-UK companies which are listed in the UK are not regulated by the City Code.

The International Stock Exchange of the United Kingdom and the Republic of Ireland Limited listing and business rules also affect, on a contractual basis, the issue and trading of securities in London. In the case of companies, it is only those companies listed on or dealt in on one of the markets of the Stock Exchange which are affected by the listing rules.

4. INTERNATIONAL CO-OPERATION - BILATERAL APPROACHES

4.1 Undoubtedly, it is desirable that regulatory bodies come to some convenient method of working, which avoids unnecessary duplication of regulation or conflict of policy. Coupled with this is the philosophy that regulation should be at a minimum level necessary to ensure protection for those who need it, and that excessive regulation produces undesirable, anti-competitive effects which are not in the interests of market customers as a whole. It is clear that no national regulator should now adopt rules for the regulation of cross-border business without taking into account the legitimate regulatory and jurisdictional interests of other states. One of the most troublesome issues to be tackled is the extent to which national regulators are entitled to regulate the activities of persons not located in their territory.

The case of futures and options trading between the UK and the US provides a current example of initial failure of international co-operation followed by later success (albeit somewhat qualified in view of some outstanding concerns).

4.2 Conflict

It became apparent (particularly after the **Alan J Ridge** case (**In re Alan J Ridge** [1982-1984 Transfer Binder] Comm. Fut. L. Rep. 21,819 (CFTC 1983) (CCH)) that the voluntary establishment of positions on US markets brings a foreign trader under the jurisdiction of the US Commodities and Futures Trading Commission (CFTC) under the US Commodity Exchange Act - even if that person instructed a U.S. broker to execute the transactions on his behalf. The Alan J Ridge case concerned the contentious issue of CFTC "Special Calls", when the CFTC called for information not only about the immediate futures trading of a client in the US, but about the foreign party's physical and futures trading generally worldwide. This information was withheld by the UK broker instructing the US broker and the UK broker obtained the first blocking order under the UK **Protection of Trading Interests Act 1980.** In response, on the application of the CFTC, the US Court barred the UK broker for a period from trading on the US markets.

It must be borne in mind that UK regulatory authorities will no doubt reflect the attitude of the British Government (more specifically the DTI) in resisting undue extraterritorial jurisdiction by US regulatory bodies. It is to be hoped that international co-operation will obviate the need for the UK to use its powers under the UK "blocking statute", **Protection of Trading Interests Act 1980.** The success of globalised trading (including linkages between Futures and Stock Exchanges) clearly depends on each Exchange and its members having faith that regulators in the other's country do not unilaterally impose damaging rules.

4.3 Mutual Recognition

There has been a recent hopeful sign in this direction. The CFTC eventually adopted in 1988 its Part 30 Rules on Foreign Futures and Foreign Options Transactions ("**the Part 30 Rules**") governing the offer and sale of foreign futures and options contracts in the USA - a subject on which the London Exchanges and the UK Government had made strong representations in the USA. Although these Regulations still contain some unsatisfactory features, foreign brokers wishing to obtain business in the USA may escape the local registration and other requirements of the Regulations by seeking an exemption based upon demonstrating comparable regulation in their own home country. The CFTC apparently expects that, procedurally, individual firms will apply for exemption in conjuction with an SRO and/or a Government agency, because of the requirement that the firm prove that there is an information sharing agreement between the CFTC and the appropriate Government or SRO.

Exemption Orders (following interim exemptions) have only recently been obtained from the CFTC (on receipt of petitions from the UK Securities and Investment Board and the relevant self-regulatory Organisation) on behalf of members of the London Futures and Options Exchanges, following long negotiations with the CFTC. The introduction of a "comparability test" was regarded as a constructive step in the search for an appropriate structure for international regulation of the futures industry. The CFTC declared that it was satisfied that the framework established by the Financial Services Act 1986 and the Rule Books of each petitioner was comparable to that prevailing in the USA.

The terms of those exemption orders are still a cause of concern for many in London who feel that the CFTC is still extending its jurisdiction into areas where it has no power to do so and that, in assessing the "comparability" of the UK regime, the CFTC has required detailed point-by-point comparability, rather than broad comparability The particular reservations concern:

- the application of CFTC rules to the acceptance of unsolicited business from US customers by UK firms;

- the attempt to extend the CFTC's jurisdiction beyond its lawful jurisdiction (even under the US Commodity Exchange Act), a point made by London Exchanges since the outset.

- the compulsory segregation of client funds for business customers doing trade business;

- the obligation for UK firms to submit to the right of US clients to have recourse to US arbitration in relation to matters which have to be settled in accordance with the relevant SRO rules.

In view of specific concerns on the part of the London Metal Exchange, the CFTC has been petitioned to permit US customers to opt out of segregation in relation to dealings with the LME. Following protracted negotiations, the CFTC has agreed in principle to an alternative arrangement , whereby bank guarantees or letters of credit could be used to safeguard the net forward profits and margin of US customers.

The general feeling of the London markets is that, since the Part 30 Rules were first drawn up, there have been significant developments in the field of international regulation, including new European regulatory initiatives. The debate on how to regulate international business has been taken up by the International Organisation of Securities Commissions. In the light of these developments, the CFTC has been urged to review the jurisdictional boundaries drawn by the Part 30 Rules and the manner in which it operates the comparability test for exemptions.

The CFTC recently announced the lifting of a ban on the sale of foreign options in the USA. In conjunction with the Part 30 Rules, applications have been submitted by the London Exchanges to enable certain London Exchange Option Contracts to be marketed in the USA. The CFTC will be examining these applications in the light of this new international regulatory environment and will, inter alia, be looking again for appropriate access to information on London markets, perhaps in the form of a memorandum of understanding with UK exchanges.

For the purposes of these exemptions, due regard has been had to a Memorandum of Understanding ("MOU") concluded on the 23 September 1986 between the DTI and the CFTC and the SEC, providing for mutual exchange of information, to which the SIB subsequently became a party. This was followed by the Financial Information Sharing Memorandum of Understanding ("FIS MOU") concluded on 1 September 1988 between, inter alia, SIB, CFTC, UK SROs and US SROs

4.4 Memoranda of Understanding

Various international co-operation agreements in the regulatory field have been executed. The first was a MOU between the United States and Japan in May 1986, followed in September 1986 by the MOU between the UK and the US referred to above. The MOU between the UK and the US covers the whole of the securities and futures industries.

This UK/US MOU in its own words:

> "sets forth the basis upon which the SEC and the DTI and the CFTC and the DTI reciprocally propose to exchange information for the purpose of facilitating the performance of their respective functions regarding the legal rules or requirements of the United States and the United Kingdom".

It is a statement of intent and not a document binding in law, although it finished by declaring that the parties will use their best efforts to enter into negotiations within 12 months of the MOU being signed to replace the MOU by a full treaty. For a variety of reasons (including the need to wait until the new UK regulatory structure created under the FSA was fully in place), little progress has apparently been made towards a treaty.

In negotiating the UK/US MOU, there were three areas which caused substantial concern to the Exchanges in London. The first was the ability of the US authorities to go on fishing expeditions for information without any precise breach of law or rule being alleged. The second was the use of the MOU to obtain information regarding "manipulation" of the market in a commodity in circumstances where the exchanges in London did not consider that manipulation was taking place. The third was the old fear that confidential trade information would be made public.

The Exchanges in London and the users of the London markets have traditionally feared that, once information falls into the hands of the US authorities, the world at large will have access to it by virtue of the **Freedom of Information Act 1967** or similar legislation in the US. Since the London markets have traditionally been used by international organisations (including many foreign governments) who wished, for legitimate commercial reasons, to keep their trading confidential, this concern on the part of London was understandable. Indeed, much work was done to satisfy London generally that adequate safeguards do exist under US law (including under the Freedom of Information Act) to prevent disclosure of confidential information.

It remains to be seen whether the terms and conditions of the UK/US MOU have successfully met the fears of the London Exchanges and users, or whether problems will arise in this area.

The MOU itself requires the SEC, CFTC and DTI not to publicise or disclose the use of the MOU. It seems that the MOU has been used on several occasions and to greater effect than most people expected. The authorities have acknowledged that information has passed in both directions. It seems that the MOU is regarded as a success by the authorities.

4 5 **Regulatory Co-operation**

The scope for co-operation is now being taken a stage further. The United States passed legislation in November 1988 to allow the SEC to carry out investigations, on behalf of foreign regulators; the CFTC also pursued similar powers as part of its application to the US Congress for re-authorisation in 1989 - 1990. Specifically, the SEC was granted authority to conduct investigations, in its discretion, to collect information and evidence pertinent to the request for assistance regardless of whether the facts stated in the request would constitute a violation of the laws of the United States. In deciding whether to provide such assistance, the Commission would consider whether:

(1) the requesting authority has agreed to provide reciprocal assistance; and

(2) compliance with the request would prejudice the public interest of the United States.

The new **Companies Act 1989** likewise permits the UK government to conduct investigation into a company or investment business on behalf of an overseas regulatory body with similar powers. Accordingly, a similar power is being given to the Minister in the UK, if satisfied that a request for assistance is appropriate for regulatory purposes. He may take other factors into account including whether the authority requesting the assistance would reciprocate. A firm or individual that fails to comply with such an investigation, without reasonable cause, is to be made liable for severe penalties. The powers for obtaining information are being simplified and increased. However, there are restrictions on the disclosure of such information, and criminal sanctions will apply against unauthorised disclosure. There are special safeguards for information covered by banking confidentiality.

All these safeguards are, of course, most important to a market sensitive to the need for protecting customer trading information confidentiality

5. INTERNATIONAL CO-OPERATION - MULTILATERAL CO-OPERATION - THE APPROACH OF THE DRAFT EC INVESTMENT SERVICES DIRECTIVE

5 1 Related issues are raised by the EC Single European Act and the objectives of "achieving the internal market". Barriers to the establishment of financial services businesses within EC countries (to the extent they operate between one EC country and another) are to be struck down in the name of harmonisation and "mutual recognition of authorisation and of supervisory systems".

A draft Directive "on investment services in the securities field" envisages "the application of the principle of home country control and the granting of a single authorisation recognised throughout the Community" Thus, although different centres within the EC may have different authorisation requirements for their "nationals" they will not, in future, be able to apply those requirements to other EC nationals wishing to establish a business in their state if those EC nationals are properly authorised in their own home country It should be noted that the directive does not confer a right of establishment or a right to provide services - these are already rights directly conferred on Community nationals by the Treaty.

The establishment of the principle of home state authorisation involves the balancing of the interest of each Member State in retaining its right to authorise EC firms doing business within its jurisdiction against the interest of the Community as a whole in reducing the barriers to freedom of establishment and freedom to provide services that 12 separate authorisation systems represent for a Community firm.

The principle of "home country control" will thus rest on a workable system of "mutual recognition" of agreed Community standards and this in turn leads to discussions and negotiations between sovereign states as to the requirements imposed in each other's "territorial jurisdiction". The more exacting states - particularly if they seem to require some degree of "up-grading" of the requirements of other states as a condition of "recognition" - may well be seen as seeking to act in an "extra-territorial" way.

Obviously, however, it would not be in anyone's interest to allow one member state to establish a notoriously weak system of regulation and thus attract the least scrupulous operators seeking a Europe-wide authorisation

5.2 The latest draft of the EC Directive is the amended proposal submitted by the EC Commission on 23 January 1990. As already indicated, this lays down the principle of "home country control". Article 3 states in only the most general terms what the conditions should be for authorisation by a "home country". Three broad requirements are mentioned:

(a) the investment firm must have sufficient initial financial resources having regard to the nature of the activity in question;

(b) the persons who effectively direct the business of the investment firm must be of sufficiently good repute and experience, and

(c) holders of "qualified participations" in the investment firm must be "suitable persons".

Continuing compliance with these requirements are "within the exclusive regulatory competence of the home member state's competent authorities irrespective of whether or not the investment firm establishes a branch or provides services in another member state" (see Article 9.3). It remains to be seen whether Member States will be prepared to give up their right to authorise branches of EC firms on the basis of the guarantee afforded by this very general wording. It would be unwise to assume that those Member States with sophisticated financial markets (and capital requirements to match) will be prepared to accept the principle of home state authorisation without a rather more precise indication of what 'sufficient initial financial resources' entails 'having regard to the nature of the activity in question'. It is unlikely that Member States will agree to adopt the Investment Services Directive without an accompanying Capital Directive spelling out in considerable detail the capital requirements for investment firms.

5.3 Article 5 contains a provision of interest to non EC nationals, ie, that "Member States shall not apply to branches of investment firms having their registered office outside the Community, when commencing or carrying on their business, provisions that result in more favourable treatment than that accorded to branches of investment firms having their registered office in a Member State". In practice this is likely to mean that a Member State would require a third country branch to be authorised in the Member State or to be subject to equivalent authorisation requirements in the third country. This may involve an element of extra-territoriality but is generally seen as less controversial than the 'reciprocity' provisions in Article 7 of the directive. These are now modelled on the Second Banking Directive which underwent substantial changes during the course of the negotiations. The Commission has justified the provisions on the basis of the need to open up third country markets; others have interpreted the provisions as an attempt to create a "Fortress Europe" to keep out third country competition. As the provisions have emerged, it is likely that the Community will be able ultimately to block the authorisation of a subsidiary of a third country firm in the Community if Community firms are not afforded 'national treatment' in the country in question.

5.4 Article 11 requires member states to draw up "prudential rules to be observed on a continuing basis by investment firms authorised by their competent authorities". Again, supervision of compliance is within the "exclusive competence" of the home member state. Article 11 gives a broad outline of what the "prudential rules" are to cover, ie

(a) sound administration and accounting procedures and internal control mechanisms;

(b) separation of client money and securities;

(c) recourse to general compensation funds, etc;

(d) provision of prudential information to authorities;

(e) keeping of adequate records for prudential purposes; and

(f) proper procedures for dealing with conflicts of interest.

5.5 Some of these rules listed in Article 11 above are clearly prudential in nature and they would therefore fall naturally within the competence of the home state prudential supervisor. Others have been characterised in the UK hitherto as more akin to Conduct of Business Rules and might therefore in the post-1992 era be regarded as the province of the host state.

Client money

5.6 The segregation of client money is seen as an essential element of investor protection. Under the Financial Services Act, authorised firms are required to keep client money in a separate client bank account on trust for the client. The rules are designed to ensure that, in the event of the firm's insolvency, client money is not treated as part of the assets of the firm for general distribution to investors and, while the firm is a going concern, client money is not used by the firm to finance its business

5.7 Whether client money rules are the responsibility of the home or the host state, questions of extra-territoriality inevitably arise. The UK - authorised firm may receive client money outside the United Kingdom in respect of a UK investment transaction. To apply the UK client money regulations to this business could lead to conflict with the law of the country in which the money is held, apart from the difficulty of enforcing the concept of trust money in jurisdictions which do not recognise the trust. The UK, in allowing authorised firms to hold client money outside the UK, requires them to inform investors that their money may not be subject to the same degree of protection as in the UK.

5.8 The Investment Services Directive allocates jurisdiction over client money rules to the home state. This has attractions, both on policy grounds and because it helps to eliminate potential conflicts of jurisdiction. The firm which finds itself in financial difficulties will often be tempted to make use of client money to support its business. Similarly a firm which has inadequate 'back office' systems may, through its failure to maintain adequate accounting records, be incapable of determining what money belongs to the firm and what money belongs to clients. The home state supervisor is responsible for ensuring that the firm has adequate financial resources and it has power to require the firm to keep adequate records and accounting systems to demonstrate compliance with prudential requirements. Giving the home state supervisor responsibility for client money can be seen as a natural extension of its prudential responsibilities.

5.9 The Investment Services Directive will allow the UK regulator to apply UK client money regulations to a UK firm carrying on investment business in any other member state of the European Community. The host state will, in return, renounce its right to apply its rules. The Directive cannot, however, eliminate at a stroke all potential conflicts which may arise. The absence of a harmonised insolvency regime for the Community will inevitably mean that, in the event of a bankruptcy of a UK firm with branches throughout the Community, investors in other member states cannot be guaranteed equivalent protection.

Compensation

5.10 The insolvency of an authorised firm will also trigger off a claim for compensation under the Investment Service Directive. It is generally accepted that the home state prudential supervisor will shoulder the responsibility, if any, for the insolvency of one of its authorised firms. Consequently it seems reasonable to place responsibility for paying compensation to investors who have a claim against the insolvent firm on the home state. However, this has the corresponding disadvantage for investors in a member state in that they may be eligible for differing amounts of compensation depending on the nationality of the firm they are dealing with. This is not an insuperable obstacle. In the UK at present, different types of institution, for example life assurance companies, building societies and other investment firms, are all subject to differing compensation provisions. In the absence of a single Community-wide compensation scheme, some divergence is inevitable, whether between Member States or within Member States.

5.11 The Commission in its draft proposal has adopted a mixture of home and host state rules for compensation. Article 11 of the Investment Services Directive provides that branches of Community firms may be made subject to host state compensation schemes; services business would remain subject to home state compensation schemes

5.12 This is unsatisfactory in several respects. First it creates a distinction between establishment business and service business. The precise difference is not always evident even to Community lawyers. For example, the Court of Justice has held that in some circumstances a person will be regarded as 'established' in a Member State even though he has not set up an agency, branch or subsidiary in that State, if his 'activity is entirely or principally directed towards its territory... for the purpose of avoiding the professional rules of conduct which would be applicable to him if he were established within that state'.

5.13 Moreover the distinction between services and establishment business is one which is increasingly irrelevant in an age of screen-based financial services. It is a distinction too which is unlikely to be immediately apparent to the average investor, but it may nevertheless dramatically affect his compensation rights.

5.14 The major drawback of the present proposals is the absence of any guaranteed minimum level of compensation. The Commission would no doubt argue that it would be premature to try to reach agreement on Community compensation levels when few Members States have any kind of domestic compensation scheme. Nevertheless the Commission has proposed that investors in the UK for example should give up their right to compensation under the UK compensation scheme when dealing with a firm doing business in the UK on a services basis but the Commission offers no guarantee in return that those investors will receive any more than a nominal sum by way of compensation.

5.15 A further complication arises from the fact that a firm can do business both on an establishment and a services basis in a Member State at the same time. Moreover a host-based compensation system requires critical decisions to be made as to whether, for example, a firm was carrying on a particular investment activity in the UK or another Member State or both.

5.16 The compensation provisions also apply to credit institutions The Commission issued a recommendation to Member States in December 1986 on the introduction of deposit protection schemes and it is likely that, following the implementation of the Second Banking Directive, there will be further moves to introduce binding requirements for deposit protection in each Member State. It is also likely that there will be pressure to move to home state responsibility for deposit protection schemes. Merging the banking and investment services regimes will be difficult: investors may be covered both by a deposit protection scheme and by an investors compensation scheme in respect of the same claim. It would add to the potential confusion if the Community were to end up with home state deposit protection arrangements and host state investor compensation schemes.

Enforcement

5.17 The division of responsibilities between home and host state envisaged by the Investment Services Directive and the Second Banking Directive has given rise to concern that the host state may have been deprived of any effective sanctions over firms from other member states who breach local requirements Once the host state is deprived of the ultimate sanction - the power to revoke a firm's authorisation, does it not have to rely on the home state supervisor to apply the necessary sanctions? In the current January 1990 draft of the Investment Services Directive, 'host states are

free to take appropriate measures to prevent or punish irregularities committed within their territories'. This expressly includes the right to stop the offending firm carrying on further business within the jurisdiction. This recognises the fact that the directive will only alter those provisions of national law which are dealt with by the Directive eg. authorisation, financial resources and other prudential requirements, client money, compensation and access to investment exchanges. All other matters which are currently within the jurisdiction of the host state remain uneffected. If the Directive does not deprive the host state of the power to lay down conduct of business rules, the host state retains that power and should likewise retain the power to provide for appropriate sanctions in the event of breach. An investment firm authorised in a Member State does not through its acquisition of the 'passport' acquire the right to ignore all local laws in a state where he carries on investment business. He remains subject like other domestic firms to all relevant national laws.

5.18 Concern has been expressed however that leaving the host state in control of conduct of business rules would encourage the retention of local requirements which act as barriers to freedom of establishment and services. Technically, a barrier to freedom of establishment which cannot be justified on grounds of the public good laid down by the Court of Justice could be challenged as contrary to Community law. Broadly speaking, a rule or regulation will only be justified on the basis of the public good test if it is proportionate to the objective to be achieved, in other words, if the same result cannot be achieved by less restrictive means. Another prerequisite is that the firm is not already subject to home state requirements which achieve the same result and, finally, there can be no discrimination on grounds of nationality. This is the existing position under Community Law, irrespective of the adoption of the Second Banking Directive and Investment Services Directive.

5.19 The solution adopted for enforcement under the Second Banking Directive, which the Investment Services Directive has now followed in the latest draft, recognises that the home and host state can coexist without requiring the host state to abandon all its rights and responsibilities.

6 CONCLUSION - FURTHER DIRECTIONS FOR WORK

As indicated above, it is felt that the level of regulation should be such as to provide adequate protection for those who need them whilst not at the same time introducing unnecessary barriers to international trade.

It is believed that a combination of the UK legislature's approach to the extent of jurisdiction claimed and the recognition of foreign regulation found in the Financial Services Act and that of the European Community in the Second Banking and Investment Services Directives produces in general terms an appropriate jurisdictional basis for a flexible regulatory system to achieve this objective.

This combined UK-EC approach recognises that a minimum standard of regulation is necessary to protect the public and that overlapping and duplicative international regulation of firms doing business on a cross-border basis is highly undesirable. Further, the approach differentiates between classes of "consumer": to provide the same protections to experienced business customers as those which are provided to the man in the street inhibits international commerce, by

increasing the cost of doing business and restricting the ability of business customers to negotiate commercial arrangements best suited to them.

In the light of developments in international regulation over the last two or three years, in particular in the European context, it is believed that greater emphasis should be placed upon home state control of prudential matters which are related to fitness and properness of licensed investment firms. In this context, the European Community's experience that, in the search for a workable international regulatory system, precise harmonisation of regulatory laws cannot be achieved demonstrates that any comparability test must be flexible and allow for considerable variations in the precise details of national regulatory treatment.

Self evidently, the structure and details of regulation will differ from state to state. It is equally self evident that the traditions, rules and practices of markets located in different states will vary. In establishing a structure for international regulation, it is imperative that national regulators respect differences in national regulation and market practices and do not attempt to use their own national regulation to create perfectly flat playing fields Diversity in market practices and structures can lead to positive benefits for customers through enhanced competition, provided that, in achieving diversity, markets do not thereby lower customer protection standards to unacceptable levels.

SCHEDULE

UK Securities and Investments Board Lead Regulation Agreements with Overseas Supervisors as at 4/4/90

A. **Securities and Futures and Options Regulators**

1. The Securities and Exchange Commission, US

2. The Commodities Futures Trading Commission, US

3. The Toronto Stock Exchange, Canada

4 The Investment Dealers Association, Canada

5. The Australian Stock Exchange, Australia

6 The Sydney Futures Exchange, Australia

7. Financial Supervision Commission, Isle of Man

8. The Central Bank of Ireland

B **Banking Supervisors**

1 The Federal Reserve Board, the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, New York State Banking Department, US

2 The Ministry of Finance, Japan

3 Bundesaufsichtsamt, West Germany

4. Commission Bancaire, France

5 Bank of Italy, Italy

6. Central Bank of Ireland, Ireland

7 Commission Bancaire, Belgium

8 Bank of Spain, Spain

9 Institut Monetaire Luxembourgourgeois, Luxembourg

10. Finanstilsynet, Denmark

11 De Nederlandsche Bank, Netherlands

12 Federal Banking Commission, Switzerland

13. Federal Ministry of Finance, Austria

14 Banking Supervision, Finland

15 Bankinspektionen, Sweden

16 **Kredittilsynet, Norway**

17. **Reserve Bank of Australia, Australia**

18. **Banking Commissioner, Hong Kong**

19. **Office of the Superintendent of Financial Institutions, Canada**

20. **Reserve Bank, New Zealand**

21. **Reserve Bank, South Africa**

22. **Financial Supervision Commission, Isle of Man**

23 **Monetary Authority of Singapore**

24 **Saudi Arabian Monetary Agency**